Supreme Court, U.S.
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No.

In The

Supreme Court of the United States

October Term, 1994

LIBERTY MUTUAL INSURANCE COMPANY,

Petitioner,

v.

CHEMSTAR, INC. AND NATIONAL UNION FIRE INSURANCE CO. OF PITTSBURGH, PA.,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals, Ninth Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED FOR REVIEW

1. Whether a United States District Court, exercising diversity jurisdiction, improperly applied Fed. R. Civ. P. Rule 42 to bifurcate trial of an action, and based thereon to limit the evidence which could be heard so as to improperly abridge the defendant's substantive state law rights under *Erie R. Co. v. Tompkins*, 304 U.S. 64 (1938) and *Hanna v. Plumer*, 380 U.S. 460.

2. Whether the $14 million punitive damages award, which was not given the mandated intensive review by either the District Court or the Court of Appeals, is grossly excessive in violation of the Due Process Clause of the Fourteenth Amendment. *Cf., BMW of North America, Inc. v. Gore* #94-896, *cert. granted* January 23, 1995.

LIST OF ALL PARTIES TO THE PROCEEDINGS

The following parties were present in the trial court action by way of a complaint filed by Chemstar and by way of third party claims: Chemstar, Inc. ("Chemstar"); Liberty Mutual Insurance Company ("Liberty")*; National Union Fire Insurance Co. of Pittsburgh, Pennsylvania ("National Union"); Industrial Insurance Company of Hawaii LTD ("Industrial"); Genstar Corporation ("Genstar"); American Home Assurance Co. ("American Home"); Employer's Insurance of Wausau ("Wausau"); and United Insurance Company ("United").

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*Corporate Disclosure Statement: Petitioner, Liberty Mutual Insurance Company, as well as Liberty Mutual Fire Insurance Company, their subsidiaries and affiliates do not issue shares to the public, except as follows: Liberty Mutual Insurance Company and Liberty Mutual Fire Insurance Company own over 12 percent of the issued and outstanding shares of Liberty ALL-STAR Equity Fund (ALL-STAR), a closed-end investment company with publicly traded shares registered on the New York Stock Exchange (Symbol: USA). Liberty Asset Management Company, a wholly-owned indirect subsidiary of Liberty Mutual Insurance Company and registered investment adviser under the Investment Advisers Act of 1940, as amended, is the investment adviser to ALL-STAR.

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Petitioner Liberty Mutual Insurance Company prays the Court for a writ of certiorari to the Ninth Circuit Court of Appeals as set forth below:

REFERENCE TO OFFICIAL AND UNOFFICIAL REPORTS OF OPINIONS DELIVERED BY THE COURT BELOW

41 F.3d 429 (9th Cir. 1994)

STATEMENT OF JURISDICTION OF THE UNITED STATES SUPREME COURT

The judgments and opinions of the Ninth Circuit Court of Appeals sought to be reviewed were filed and entered November 16, 1994. The Ninth Circuit Court of Appeals' order denying rehearing and rehearing en banc was filed December 28, 1994.

This Court is vested with jurisdiction to review the Ninth Circuit Court of Appeals' decision pursuant to 28 U.S.C. section 1254(1).

TEXT OF PERTINENT CONSTITUTIONAL PROVISIONS, STATUTES, ORDINANCES AND REGULATIONS

Fed.R.Civ.P. 42(b)

> **(b) Separate Trials.** The court, in furtherance of convenience or to avoid prejudice, or when separate trials will be conducive to expedition and economy, may order a separate trial of any claim, cross-claim, counterclaim, or third-party claim, of any separate issue or of any number of claims, cross-claims, counterclaims, third-party claims, or issues, always preserving inviolate the right of trial by jury as declared by the Seventh Amendment to the Constitution or as given by a statute of the United States.

Rules Enabling Act 28 U.S.C. section 2072

§ 2072. Rules of procedure and evidence; power to prescribe

(a) The Supreme Court shall have the power to prescribe general rules of practice and procedure and rules of evidence for cases in the United States district courts (including proceedings before magistrates thereof) and courts of appeals.

(b) Such rules shall not abridge, enlarge or modify any substantive right. All laws in conflict with such rules shall be of no further force or effect after such rules have taken effect.

(c) Such rules may define when a ruling of a district court is final for the purposes of appeal under section 1291 of this title.

Rules of Decision Act 28 U.S.C. section 1652

§ 1652. State laws as rules of decision

The laws of the several states, except where the Constitution or treaties of the United States or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the courts of the United States, in cases where they apply.

Supreme Court Rule 10.1(a)

[A petition for writ of certiorari may be granted]

(a) When a United States court of appeals has rendered a decision in conflict with the decision of another United States court of appeals on the same matter; or has decided a federal question in a way in conflict with a state court of last resort; or has so far departed from the accepted and usual course of judicial proceedings, or sanctioned such a departure by a lower court, as to call for an exercise of this Court's power of supervision.

Amendment XIV, Section 1, United States Constitution

Section 1. Citizens of the United States.

All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside. No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny any person within its jurisdiction the equal protection of the laws.

STATEMENT OF THE CASE

A. Manufacture and Sale of Lime For Plaster

Through the mid-1980s, Genstar, a large Canadian conglomerate, manufactured lime to be used for plastering interior and exterior building surfaces.[1]

Genstar Lime Company, before the corporate changeover to Chemstar, manufactured some lime which contained excessive amounts of magnesium oxide, also called periclase. Even though this excess-periclase lime is used for plastering exterior surfaces, when used on interior surfaces, depending upon the atmospheric conditions

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[1] Lime was actually manufactured by a Genstar subsidiary, Flintkote, through Flintkote's lime division, Genstar Lime Company ("GLC"). In the mid-1980s, GLC was changed from a lime *division* of Flintkote into a *subsidiary company* wholly owned by Flintkote. At about that time a separate corporation, "Newco", was created to purchase GLC. GLC purchased all of Flintkote's lime assets thereby divesting Genstar of all interest in the lime business. Newco purchased the stock of GLC and then Newco changed its name to Chemstar, Inc. (a Nevada Corporation). On December 5, 1986, the sale of GLC to Chemstar, Inc. was completed. Through an additional series of corporate changes and mergers, the present "Chemstar, Inc.," an Arizona Corporation, was formed. (See chart at Appendix ["A"] A-111.)

in the particular building, the plaster surface may "pit" or "pop." This disfigurement to the interior plastered walls is referred to as "plaster-pitting." (A-8.)

B. Insurance Purchased by Genstar and Insurance Purchased by Chemstar

Genstar purchased its primary insurance policies from Liberty during the time frame relevant here. Genstar purchased a policy from Liberty dated March 15, 1984 to March 15, 1985 (the "84 policy"). Genstar also purchased a policy from Liberty dated March 15, 1985 to March 15, 1986 (the "85 policy"). Genstar's final policy from Liberty covering any lime operations ran from March 15, 1986 to December 5, 1986. Genstar expressly requested Liberty to cancel all coverage which had formerly been afforded to its lime operations when those operations were purchased by Chemstar on December 5, 1986. (See Clerk's Record 1; EOR-L 139, 101.[2])

Chemstar purchased its own insurance from National Union effective December 5, 1986, which continued at least through October of 1988.[3] (A-108.)

C. Twenty-eight Plaster Pitting Claims

The interior surfaces of numerous individually owned and built homes over a wide geographical area in southern California were plastered with lime containing excess periclase. Interior walls plastered with the excess-periclase lime do not inevitably pit or pop; however

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[2] EOR-L refers to Liberty's excerpts of record, submitted with its briefing of the Phase II appeals in the Ninth Circuit.

[3] Various excess insurers also provided coverage above the primary policies issued by Liberty to Genstar and above primary policies issued by National Union to Chemstar. The carriers and their limits, to the extent they are involved in this case, are included on a chart in the appendix at p. 108.

disfigurement became apparent in 28 homes and was noticed by the homeowners over a span of at least 4 years. (A-9.)

1. Insurance Coverage for the Plaster Pitting Claims

Some of the plaster damage was noted by homeowners while Genstar was the parent company over the lime operations. Genstar tendered those claims to Liberty, which defended and paid for those property damage claims. (EOR-L 154.)

In at least one claim, for plaster damage in the Friedman house, pitting manifested after Chemstar purchased its own insurance through National Union. Chemstar tendered that claim to both Liberty and to its insurer, National Union. Liberty declined to cover the Friedman claim for two reasons: 1) the damage happened after Liberty's policy was canceled and 2) Chemstar was not Liberty's insured. (EOR 1-2.[4]) Although Liberty had insured *Genstar* on the lime claims, that coverage was canceled when Chemstar was formed, whereupon Chemstar purchased its own insurance. National Union, Chemstar's own insurer, also declined to cover the Friedman claim.

Whether or not the Friedman claim is covered under Liberty's (or National Union's) policy presents a legal question under California law. At least two cases are presently pending in the California Supreme Court to decide which of several serial policies may be "triggered" for coverage in a third party property damage situation.[5]

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[4] EOR refers to Liberty's excerpts of record for the Phase I appeal.

[5] *Montrose Chemical Corp. v. Admiral Ins. Co.*, 15 Cal.App.4th 975, 5 Cal.Rptr.2d 358 (1992), *review granted* 24 Cal.Rptr.2d 661; and *Stonewall Ins. Co. v. City of Palos Verdes Estates*, 13

There is at least one valid and existing third party property damage case in which a California Court of Appeal determined that the insurance policy in effect when *each* discrete instance of property damage happens is triggered for coverage. (*Whittaker v. Allianz Insurance Co.*, 11 Cal.App.4th 1236, 14 Cal.Rptr.2d 659 (1992).) There is also valid and existing case authority stating that insurance coverage from a predecessor corporation does not inure to the benefit of the successor corporation under circumstances analogous to the present case. (*Northern Insurance Co. of New York v. Allied Mutual Ins. Co.*, 955 F.2d 441 (9th Cir. 1992) and *Quemetco, Inc. v. Pacific Automobile Ins. Co.*, 24 Cal.App.4th 494, 29 Cal.Rptr.2d 627 (1994).) (See A-23-24; A-27-28.)

2. Suit by Chemstar

Chemstar sued various insurers in state court. The action was removed to federal court, Central District of California, pursuant to 28 U.S.C. § 1332 (diversity jurisdiction). Chemstar's complaint and later amended complaints requested declaratory relief and asserted causes of action for breach of contract and breach of the implied covenant of good faith and fair dealing.[6] Various insurers and issues were brought into Chemstar's action by third party counterclaims and cross-complaints. Among other matters, contribution rights between insurers were asserted by cross-claims and counterclaims. (A-9.)

Cal.App.4th 226, 9 Cal.Rptr.2d 663 (1992), *review granted* 11 Cal.Rptr.2d 329 have both been fully briefed but no oral argument has yet been set on these cases.

[6] It is the claim of breach of the implied covenant of good faith and fair dealing to which tort *damages* may apply that carries the potential, if opprobrious conduct is shown, for punitive damages. (Cal.Civ.Code., § 3294.)

D. Sua Sponte Bifurcation by the Court Requiring Determination of Liberty's "Bad Faith" and Punitive Damages BEFORE Determination of Coverage Issues

The trial court *sua sponte* bifurcated trial of this case. (A-9-10.) Appallingly, the trial judge ruled that issues of Liberty's bad faith and the propriety and amount of punitive damages against Liberty would be determined in a first, separate trial *before* determination of coverage issues, before adjudicating whether other insurance companies besides Liberty may owe defense or indemnity obligations for the various plaster claims and *before* it was adjudicated whether any other insurer had any part in covering or defending the *Friedman claim*.

E. Phase I Trial

A jury was impanelled to hear testimony regarding Liberty's purported breach of the implied covenant of good faith and fair dealing. Chemstar was permitted to assert that Liberty acted in "bad faith" in denying the Friedman claim to avoid a "big hit" (*i.e.*, to avoid having to pay for the plaster claims).[7] Crucial evidence that could show Liberty was not trying to avoid paying plaster claims and evidence that Liberty had no evil motive regarding the Friedman claim was not allowed in the Phase I trial where "bad faith" and punitive damages were determined. The court refused to allow Liberty to defend itself by telling the jury that it had defended *other* plaster pitting claims and that it had paid them. Liberty was not permitted to put on testimony regarding the retrospective nature of its premiums to show that *Liberty* would not be paying the losses out of its corporate funds

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[7] Chemstar's counsel asserted that Liberty was seeking to avoid paying $40 million in liability.

but instead the insured would be charged additional premium. Liberty was precluded from bringing evidence to the jury regarding National Union's role in coverage and its concurrent denial of a defense for the Friedman claim. All these matters were excluded because the court believed they were relevant only to the coverage matters and not to Liberty's liability for potential breach of the implied covenant of good faith and fair dealing. (A-87-88; A-78-79.)

The jury awarded damages to Chemstar of $750,000 for plaster damage in the Friedman house,[8] approximately $2 million in attorney fees and *$14 million in punitive damages.* (A-71-72.)

Liberty moved for a new trial (and for judgment in its favor) in large part because imposition of liability for "bad faith" was erroneous and because imposition of punitive damages was erroneous, excessive and in violation of its due process rights. The trial court denied Liberty's post-trial motions without detailed, substantive review of the punitive damages. (A-76-79; A-84-86.)

Liberty timely appealed from the $17 million judgment.

F. Phase II Trial

While the appeal from the Phase I money judgment was proceeding, Phase II of trial regarding insurance coverage issues commenced. On summary judgment, the district court ruled that all plaster damage claims, which had arisen over a period of more than four years, were covered under the single policy in effect when the first damage manifested in the first house. This first damage,

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[8] The Court of Appeals ruled that it was error for the trial court to assess damages for indemnity in Phase I, *before* coverage was determined. The Ninth Circuit panel went on, however, to term the error "harmless" in light of the later, Phase II coverage determination. (A-36-37.)

according to the court, appeared during Liberty's 1985 policy period. Therefore, all of the plaster claims were covered under the primary and excess coverage in effect during the period March 15, 1985 to March 15, 1986. (A-10; A-100.)

The trial court also ruled that the limits of Liberty's 1985 policy became exhausted on *April 17, 1991*. The court further ruled in its final order on Phase II issues that Liberty had no further obligations after April 17, 1991 to provide insurance coverage for plaster claims. (A-100-101.) However, Liberty had been held responsible for all of Chemstar's defense costs during the Phase I trial, even those that were incurred after April 17, 1991. Nonetheless, the district court gave no effect to that exhaustion and refused to correct the previous judgment from Phase I wherein Liberty had been held responsible for post-exhaustion sums.

Moreover, in the coverage phase of trial, the district court ruled that National Union, *Chemstar's* post-December 1985 insurer, also had a triggered duty to defend. However, the district court declined to require National Union to pay any of Chemstar's defense costs in light of its *other determination* that Liberty, not National Union, would be required to indemnify Chemstar for all damages for all 28 plaster claims. (A-104.)

The final judgment entered by the trial court on Phase II insurance coverage issues was appealed by Liberty. Chemstar also filed a notice of appeal as did three other insurers. Separate briefs were taken by the Ninth Circuit Court of Appeals regarding the Phase II judgment.

G. Ninth Circuit Court of Appeals Decisions

All appeals, including the Phase I appeal between Chemstar and Liberty only and the five Phase II appeals, were consolidated by the Ninth Circuit.

The Ninth Circuit Court of Appeals, in a published decision, opined that the California Supreme Court will rule that a manifestation trigger applies in a third party property damage case. (A-17-18.) It affirmed the trial court's application of the manifestation trigger so as to make Liberty responsible for all 28 plaster damage claims under its single 1985 policy, including those claims in which *damage* manifested after Liberty's coverage was terminated. In so doing, the Court of Appeals acknowledged that *Whittaker v. Allianz* is the "closest case" on the precise coverage issue here and it arguably supports Liberty's coverage position, but it declined to apply the case. (A-23-24.)

In unpublished memoranda, the Ninth Circuit panel affirmed all other aspects of the trial court's disposition. The panel acknowledged important authority favoring Liberty in its position that even an incorrect decision on an unsettled legal issue cannot amount to bad faith by an insurer, but the Court declined to apply that case law here. (A-29-30; A-41 [dissent on this issue].) The panel summarily approved the finding of "bad faith" on the part of Liberty.

The panel affirmed the award of $14 million in punitive damages and virtually summarily approved the trial court's disposition of every other aspect of this case. (A-26-49.)

H. Rehearing and Rehearing En Banc

Liberty and others requested rehearing and suggested rehearing en banc. Liberty reiterated the substantial authority that had been before the Ninth Circuit for the proposition that, under the circumstances present in this case, Liberty's declination of coverage for the Friedman claim could not amount to a finding of "bad faith" and as a matter of law, Liberty could not be liable for punitive damages. Liberty again raised the bizarre bifurcation of this case as being at the heart of the problem

and urged the court to rule that punitive damages violated Liberty's due process rights under the Constitution. Rehearing and the suggestion for rehearing en banc were denied on December 28, 1994. (A-115-116.)

I. Stay of Mandate and Certiorari

Following the granting by the Ninth Circuit of Liberty's motion for stay of mandate, Liberty timely petitions this Court for certiorari.

REASONS FOR GRANTING THE WRIT

I.

THE DISTRICT COURT ABRIDGED LIBERTY'S SUBSTANTIVE STATE RIGHTS WHEN IT APPLIED THE KNIFE OF FED. R. CIV. P. RULE 42 ERRONEOUSLY

A. The District Court Failed to Consider The Scope of Liberty's State Substantive Rights When Bifurcating Under Rule 42

1. Introduction: The Nature of the *Erie* Issue

The *Erie* issues raised in this case derive from the way in which the district court *sua sponte* broke this action into separate phases, and compartmentalized what points could be raised and evidence presented in each phase. By proceeding in this fashion, the court seriously abridged rights which Liberty had both in terms of the evidence it could present to defend itself against the bad faith and punitive damages claims asserted by Chemstar, and its entitlement to prosecute contribution claims against Chemstar's own primary insurer, National Union.

Throughout the 56 years since *Erie R. Co. v. Tompkins*, 304 U.S. 64 (1938), "The question whether state or federal law should apply on various issues arising in an action based on state law which has been brought in federal court under diversity of citizenship jurisdiction has troubled this Court. . . . " (*Walker v. Armco Steel Corp.*, 446 U.S.

740, 744 (1980).) "It is unquestionably true that up to now *Erie* and the cases following it have not succeeded in articulating a workable doctrine governing choice of law in diversity actions." (*Hanna v. Plumer*, 380 U.S. 460, 474 (1965) (Harlan, J., concurring).) In the present case these difficulties arise in a context not considered by this Court's prior decisions. The conflict which must be resolved does not arise because of a patent difference between two competing procedural rules, as in prior *Erie* cases. It arises because a federal rule, valid on its face, has been misapplied so as to change substantive rights regarding (1) what evidence could be considered by the jury hearing the punitive damages and "bad faith" claims against Liberty, and (2) whether Liberty could pursue its cross-claim for contribution against another insurer.

In the district court Chemstar moved for summary judgment against Liberty only, seeking a ruling that Liberty was required to defend it in the underlying plaster pitting cases, and had acted in bad faith in not defending it. The district court granted Chemstar's motion *except on the issue of whether or not Liberty breached an implied covenant of good faith and fair dealing*, and held that a trial was necessary on that point. In subsequent meetings with counsel the district court announced *sua sponte* that to move the case along it would have a separate trial against only Liberty on bad faith and damages issues. "Coverage issues" would be taken up later.[9]

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[9] Trials of complex insurance coverage/bad faith actions frequently are bifurcated to assure orderly consideration of issues as follows: Insurance *coverage* issues (declaratory relief) are determined first. After the court has interpreted the insurance contracts at issue, then a jury is impanelled to determine whether any insurer *breached* the contract as interpreted by the court. The jury then determines whether the breach, if one was found – under all the circumstances – was in violation of an implied covenant of good faith and fair dealing in the contract. Then, again considering all the circumstances, the jury determines what damages, including punitive damages, might apply.

Before the Phase I trial Chemstar filed, and the district court granted, an *in limine* motion to preclude Liberty from showing (1) that Liberty, though it refused to defend Chemstar, was defending Genstar, Flintkote, and "Genstar Lime Company" in the underlying actions, and settling cases on their behalf, (2) that Liberty's policies had limits of coverage which were almost inevitably going to be exhausted whether Liberty did or did not owe coverage to Chemstar, and (3) that the policies which Liberty issued to Genstar were retrospectively rated, so that premiums were charged back to Genstar based upon the costs incurred in defending and paying for cases assigned to that policy. The district court reasoned that these were "coverage issues" which should not be heard during the bad faith/damages trial against Liberty.

2. The California Substantive Law Relating to Bad Faith Cases

The substantive law of California provides that an insurer accused of acting in bad faith is entitled to present to the jury *all* of the surrounding circumstances that bear on its understanding and intent.[10] These cases hold

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[10] Even if an insurer acts in bad faith under California law, that fact simply creates a remedy in tort in addition to breach of contract; it does not automatically render the insurer liable for punitive damages. To be liable for punitive damages, the insurer must be independently proven to have acted with malice, fraud, or oppression. Actions by an insurer which are "negligent," "overzealous," "legally erroneous," or even "callous" do not support an award of punitive damages; the insurer's conduct must be "evil, criminal, recklessly indifferent to the rights of the insured, or with a vexatious intent to injure." (*Tomaselli v. Transamerica Ins. Co.*, 25 Cal.App. 4th 1269, 31 Cal.Rptr.2d 433 (1994); see also, *Patrick v. Maryland Cas. Co.*, 218 Cal.App.3d 1574, 1576, 267 Cal.Rptr. 24, 31 (1990) [even where insurer's claims handling practices "were shoddy, [and its] handling of the claim sought by the respondent was at times witless and infected with

that a finding of bad faith calls for the jury to draw inferences with respect to such intangibles as motive and intent, and that accordingly "the issue of whether good faith was exercised covers a broad range of territory." (*Walbrook Ins. Co. v. Liberty Mutual Ins. Co.*, 5 Cal.App.4th 1445, 1456, 7 Cal.Rptr.2d 513 (1992).) The jury must be allowed to engage in "a wide-ranging inquiry into such intangibles as motive, knowledge, experience, and the ability to prophesy." (*Id.*; see also, *Brown v. Guarantee Ins. Co.*, 155 Cal.App.2d 679, 689, 319 P.2d 69, 75 (1957) [in addition to seven specific factors that had to be weighed, the jury should consider "any other factors tending to establish or negate bad faith on the part of the insurer."]; *Davy v. Public National Ins. Co.*, 181 Cal.App.2d 387, 394, 5 Cal.Rptr. 488 (1960).)

3. In Bifurcating Trial Under Rule 42 The Court, In Order To Avoid Prejudice to the Litigants, Must be Mindful That Some Evidence May be Relevant to More Than One Phase of Trial

The issues that arose in this case concerning the use of separate trials are serious enough, and will arise in so many other complex insurance coverage actions, that review is appropriate under the Court's supervisory power over the lower federal courts. (Supreme Court Rule 10.1(a).)

Several decisions from other circuits hold that possible prejudice to the party opposing a bifurcated trial is the most serious consideration that the court must weigh in connection with separate trials under Fed.R.Civ.P.

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symptoms of bureaucratic inertia and inefficiency," punitive damages had to be reversed because there was no "consistent and unremedied pattern of malicious, fraudulent, or oppressive practices"].)

42(b).[11] Even in the relatively straightforward situation of liability and damages, the Fifth Circuit has indicated that separate trials "must be approached with trepidation" because of the possibility that issues may overlap and it may be difficult to be sure in which trial phase evidence fits. (*Response of Carolina, Inc. v. Leasco Response, Inc.*, 537 F.2d 1307, 1324 (5th Cir. 1976).) Even when such trials are permitted,

> The trial court must be careful as well as flexible in its ruling on the admissibility of evidence under a bifurcation order. Simply because evidence contains numbers or amounts, for example, should not result in its exclusion in Phase I [liability]. If causation or fact of damage cannot be shown without some reference to amount of damage, bifurcation should not prevent the reference.

(See also, *State Mut. Life Assur. Co. of America v. Arthur Andersen & Co.*, 63 F.R.D. 389, 390 (S.D.N.Y. 1974) [bifurcated trials not appropriate because they would delay and thus "severely prejudice" one defendant's contribution claims against another].)

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[11] The burden of showing a need for separate trials is on the party seeking them, and, "[t]he party seeking bifurcation 'must show that he will be prejudiced if separate trial is not granted.' " *Marshall v. Overhead Door Co.*, 131 F.R.D. 94, 97 (E.D.Pa. 1990), (quoting 5 *Moore's Federal Practice* ¶ 42.03[1].) Separate trials are only seldom appropriate, and "the movant [for separate trials] must make a showing that he will be seriously prejudiced without a separate trial. Also, the issues to be tried must be so distinct and separable from the others that a trial of it [sic] alone may be had without injustice." (*Lusk v. Pennzoil United, Inc.*, 56 F.R.D. 645, 647 (N.D.Miss. 1972).) "Perhaps the most important consideration for a court ruling on a motion to bifurcate is whether separate trials would unduly prejudice the non-moving party." (*Willemijn Houdstermaatschaapij BV v. Apollo Computer*, 707 F.Supp. 1429, 1435 (D.Del. 1989).)

4. Liberty Was Deprived of its Right To Defend Itself With Evidence Relevant Under the Governing State Law, In Violation of *Erie* and the Rules Enabling Act

Even though the jury was allowed to hear from Chemstar that Liberty "abandoned" Chemstar in order to avoid a "big hit" of tens of millions of dollars, the Court did not allow Liberty to show that it was defending Chemstar's predecessor companies (Liberty's direct insureds), settling and paying other plaster claims, or that its limits of coverage were only a fraction of the grandiose sums referred to by Chemstar. Nor was Liberty allowed to show that much of what it might spend on defense and indemnity *could be charged back to Genstar* by the applicable retrospective premiums so that Liberty *could not* be attempting to avoid any "big hit" as asserted by Chemstar. With the facts known to the jury so limited, it is not surprising that the jury awarded the millions of dollars of punitive damages that it did. Had the trial not been bifurcated as it was, and had the jury been allowed to hear during the "Liberty bad faith" phase what it was required to consider under California law, it likely would have concluded that even if Liberty erred in its conclusion about whether it owed coverage to Chemstar besides the other companies Liberty was covering, its motives could not possibly have been what Chemstar contended.

The rulings by the district court would not have been allowed in a California state court. Separate trials are allowed under California Code of Civil Procedure § 598, but the decisions applying it do not allow the rule to be used so as to alter substantive rights. In *In Re Marriage of Allison*, 189 Cal.App.3d 849, 854, 234 Cal.Rptr. 671, 674 (1987), the California Court of Appeal held that the appellant's substantive rights could not be altered just because the trial court found it convenient to hold separate trials on related issues:

> As should be obvious, it is fundamentally unfair to allow appellant's property rights to be conclusively determined by a trial court's decision to bifurcate its judgment. This act, taken for the benefit of the trial court, should not divest appellant of any substantive rights.

Where liability issues are interrelated, it is an abuse of discretion for a California court to hold separate trials on those issues. (*Cook v. Superior Court for County of San Diego*, 19 Cal.App.3d 832, 833, 97 Cal.Rptr. 189 (1971) [error to bifurcate trial of interwoven legal and medical malpractice claims when doing so alters the order of proof].)[12] (*Cf. Downey Sav. & Loan Ass'n. v. Ohio Cas. Ins.*, 189 Cal.App.3d 1072, 1086, 234 Cal.Rptr. 835, 841 (1987), *cert. denied*, 486 U.S. 1036 (1988) [appropriate to deny motion for separate trials when "the evidence on the issue of [insurer's] bad faith was interrelated with the issue of coverage under the bond. . . . "].)

5. Liberty Was Also Deprived of its Right to Contribution Under the Governing State Law, In Violation of *Erie* and the Rules Enabling Act

The district court's use of Rule 42 and backwards compartmentalization of issues pursuant to it led the court to disregard controlling state law in other respects. The district court's summary judgment ruling against Liberty on the duty to defend was based upon the argument that both the facts in the underlying plaster pitting cases, and the legal standard that would determine which insurers had coverage concerning them, were unclear. Thus, the district court reasoned, there was a "potential"

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[12] *Cook* involved a prior version of Code Civ. Proc., § 598, but that does not undercut the fundamental point that the procedural device of separate trials cannot be used to change substantive results.

for coverage that meant that Liberty was obligated to defend Chemstar, regardless of whether its policies ultimately were determined to provide coverage for the underlying cases.

Chemstar's own primary insurer, National Union, for reasons it has never been obliged to explain, also declined to defend Chemstar in the underlying cases. It, too, was sued for compensatory and punitive damages for bad faith. Even the district court acknowledged that at the outset of the coverage litigation *National Union had the same "potential" for coverage as did Liberty, and likewise owed a defense.*

The insurer defendants asserted cross-claims against one another for shares of defense costs of indemnity for the underlying cases. Because of the way in which it separated the trial of "coverage issues" until the *end of the proceedings*, at which point it determined that the applicable property damage "occurred" only during Liberty's policy period and not National Union's, the district court absolved National Union from owing any portion of the costs of defending Chemstar.

In reaching this result the district court again violated governing California law. California law requires that an insurer's duty to defend is measured by the complaint against the insured, not by a hindsight consideration of whether the claim turns out to be covered. (*Horace Mann Ins. Co. v. Barbara B.*, 4 Cal.4th 1076, 17 Cal.Rptr. 210, 846 P.2d 792 (1993).) It also establishes that when more than one insurer owes a duty to defend a policyholder, those insurers are obligated among themselves to defray their proportionate share of those costs. (*Continental Ins. Co. v. Zurich Ins. Co.*, 57 Cal.2d 27, 35-38, 17 Cal.Rptr. 12, 366 P.2d 455 (1961); *Hartford Acc. & Indem. Co. v. Superior Court*, 29 Cal.App.4th 435, 34 Cal.Rptr.2d 520 (1994).) There was no principled reason to sever out Liberty rather than National Union for rulings on duty to defend and then a trial on bad faith. Purely because of the

way in which issues were separated for trial, Liberty alone was adjudged liable for 100% of Chemstar's defense costs (and for punitive damages for not defending), and National Union was relieved of any obligation to either Chemstar or Liberty.

B. The Supreme Court Should Establish Guidelines For Lower Courts Which Use Rule 42 in the Efficient Administration of Cases

Since *Erie* was decided this Court has enunciated several formulas to explain the decision's foundations and application in the varied ways in which state and federal issues can intertwine in diversity cases. (See, *e.g.*, *York v. Guaranty Investment Trust*, 326 U.S. 99 (1945); *Byrd v. Blue Ridge Rural Electric Cooperative, Inc.*, 356 U.S. 525 (1958).)

By the time of *Hanna v. Plumer*, 380 U.S. 460 (1965), the Court recognized "two separate lines of cases" in the *Erie* decisions. (*Id.* at 471.) On the one hand were those diversity cases where no federal rule of evidence or procedure had to be reconciled with a different state rule. In those instances "state law must govern because there can be no other law." (*Id.* at 471-72.) The second type of case was where a federal and state rule both appeared to cover the same ground but in a different way. In those cases the inquiry turned to whether the federal rule was within the power given by Congress in the Rules Enabling Act (28 U.S.C. § 2072), and the Constitution.[13] If it was, the federal rule applied.

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[13] In making this determination the court must consider whether the federal rule "really regulates procedure – the judicial process for enforcing rights and duties recognized by substantive law," and is within the "long recognized power of Congress to prescribe housekeeping rules for federal courts even though some of those rules will inevitably differ from comparable state rules." (380 U.S. at 464, 473.) The critical point

The case at bar does not fall squarely within either line of authority. The Federal Rules of Civil Procedure obviously allow the trial court to separate issues when doing so will simplify trial. So do California provisions. The *Erie* issue in the present case does not lie in an overt difference between the federal and state procedural provisions. It lies in the way that a misapplication of the federal provision has been permitted to contort important substantive rules created under state law. Those *state-created* rules provide the rules of decision that govern the substantive issues such as what a jury must find, and what evidence it must be allowed to consider, in order to impose punitive damages. Likewise, state rules govern what rights Liberty has toward another insurer (in this case Chemstar's own primary insurer) for contribution for defense costs when both carriers have the same "potential" for coverage.

Both the Rules Enabling Act and the fundamental policies underlying *Erie, Hanna v. Plumer* and cases following them forbid federal courts sitting in diversity to change substantive rights created under governing state law by the application of procedural rules such as Rule 42. The Rules Enabling Act provides that the Rules of Civil Procedure and Evidence which can be adopted for the federal courts by this Court "shall not abridge, enlarge or modify any substantive right." (*Cf., Douglas v. NCNB Texas Nat. Bank*, 979 F.2d 1128 (5th Cir. 1992), *cert. denied*, 114 S.Ct. 68 (1993) [would be error to allow federal counterclaim rule to change rights under Texas law between borrower and lender].)

What a jury evaluating whether Liberty acted in bad faith must be allowed to hear, and must find, in order to

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is to effectuate the "twin aims" of *Erie*, "discouragement of forum-shopping and avoidance of inequitable administration of the laws," (*id.* at 468), and not to alter by procedural rules substantive rights existing under state law.

support an award of punitive damages, is clearly an issue regulated by California law. So is Liberty's right to seek contribution for defense costs from another insurer with the same "potential" for coverage, and thus the same duty to defend under California law, as Liberty. The district court's use of Rule 42 in too narrowly circumscribing the issues for trial, and restricting what Liberty was permitted to argue in the respective pieces, not only produced an unfair result, but violated Liberty's rights under *Erie* and related cases, the Rules of Decision Act and the Rules Enabling Act, and ultimately, the Constitution.

How separate trials may be structured under Rule 42 is an issue that is guaranteed to occur with regularity in complex insurance coverage cases such as the one at bar. Insurance coverage litigation "has experienced tremendous growth recently," and the amount of environmental coverage litigation is "exploding," as virtually every major corporation engages in insurance coverage litigation with its carriers over a period of years, often decades, with respect to Superfund liabilities. (J. Stratton Shartel, *Patent, Breach of Contract Cases Lead Growing Areas of Litigation*, 8 No. 3 Inside Litigation 1 at Westlaw p. 4 (April 1994) ("*Shartel*").)

Guidance from this Court is needed in managing this complex litigation. "In a typical case, [there will be] multiple insurers doing battle with the company that sued them." (*Shartel, supra*, at Westlaw p. 4.) Given the difficulties of managing such litigation, it is a certainty that many of these cases will be tried in pieces (as was the present case), whether broken down by sites, types of sites, coverage issues, types of policies, or otherwise. Bifurcation, properly employed, can be a useful and time saving tool in such cases.[14] Used improperly, as here, it can give rise to serious injustice.

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[14] The amount of such litigation pending led the American Bar Association's Section of Litigation to promulgate a manual

II.

THE $14 MILLION PUNITIVE DAMAGES AWARD ARISING FROM THIS INSURANCE DISPUTE VIOLATES DUE PROCESS GUARANTEED BY THE UNITED STATES CONSTITUTION

A. This Court's Scrutiny of Punitive Damages Arising in a Complex Insurance Coverage Scenario is Urgently Needed

Insurance coverage disputes such as this are legion and give rise to claims for punitive damages across the nation. As this case demonstrates, punitive damages in an insurance context tend to be in vast sums based on the *net worth of the insurer* named as a defendant, rather than the "harm" resulting from the coverage decisions the insurer has made.

Whether punitive damages are appropriate *at all* in such disputes, and the intensity of trial court and appellate scrutiny that must be afforded to these awards, are matters encompassed in the award of punitive damages in this case. These issues also are inherent in punitive damages awards across the nation and are matters that

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similar to the *Manual for Complex Litigation*, to discuss the case management issues inherent in such disputes. (*Manual for Complex Insurance Coverage Litigation*, Prentice Hall, 1993.) The section on trial management *comments* that, "In some cases a phased, or segmented, approach to trial can make trial preparation more efficient, avoid jury confusion and increase efficiency," depending on the issues in the case, what remains unresolved following dispositive motions, and other factors. (*Id.*, § 6.03.) The manual also points out prophetically that, "The demarcation between phases may not be clearly defined, and evidence presented in 'one phase' may be directly relevant to a subsequent phase." (*Id.*)

See, Kevin M. La Croix, *Trial Bifurcation Provides Important Benefits to Insurers*, 7 No. 10 Inside Litigation 15 at Westlaw p. 1 (October 1993) [a bifurcated trial tends to take twenty percent less time to try than a nonbifurcated trial.]

have not been addressed by this Court's previous rulings on punitive damages. In *BMW of North America, Inc. v. Gore*, #94-896, *cert. granted* January 23, 1995, in which $2 million in punitive damages were imposed in a commercial context, the petitioner contended that "the circumstances [there] strongly suggest that . . . something is not right." (Petition at p. 11.) The same is true here. Millions of dollars in punitive damages were imposed in a complicated commercial dispute where the punished party applied the "closest" relevant law in its coverage decision; was not asserted to have engaged in any "pattern or practice" of opprobrious conduct; and, as a result of the bifurcation of issues, could not defend itself with crucial facts that undercut the central argument in the plaintiff's punitive damages theory. At a minimum, certiorari should be granted here pending this Court's decision in *BMW*.

B. Several Objective Factors Demonstrate the Unreasonableness of the $14 Million Punitive Damages Award in This Case

This Court has ruled that although a mathematical bright line cannot be drawn between constitutionally acceptable and constitutionally unacceptable imposition of punitive damages, a " 'general concern for reasonableness . . . properly enters into the constitutional calculus.' " (*TXO Production Corp. v. Alliance Resources Corp.*, 113 S.Ct. 2711, 2720 (1993) quoting *Pacific Mutual Life Ins. Co. v. Haslip*, 499 U.S. 1, 18 (1991).) This Court has recognized that the due process clause of the Fourteenth Amendment imposes an outside limit of reasonableness on awards of punitive damages. (*TXO Production Corp., supra*, at 2720, n. 24.)

Objective factors as applied to this case, as more fully set forth below, demonstrate that imposition of $14 million in punitive damages against Liberty is beyond that outer limit of reasonableness.

1. Fourteen Million Dollars is Unreasonably Excessive Punishment for an Insurer's Guessing Wrong About Coverage

Whether the defendant's conduct is opprobrious is a factor to be considered in determining whether punitive damages have been imposed in violation of due process under the Fourteenth Amendment. (*See, Pacific Mutual Life Ins. Co. v. Haslip*, 499 U.S. at 21.) This Court has ruled that in considering whether a punitive damages award violates the United States Constitution as unreasonable, it is appropriate to consider the magnitude of the potential *harm* that the defendant's conduct would have caused to its intended victim as well as the possible harm to other victims that might have resulted if similar future behavior were not deterred. (*TXO Production Corp., supra*, 113 S.Ct. at 2721.) Here, the conduct for which punitive damages was imposed and the actual and potential "harm" at stake is the possibility that an insurer may incorrectly decline to provide coverage under an insurance policy.

In this case, the dispute leading to imposition of $14 million concerns Liberty's interpretation of and application of as yet unsettled law affecting coverage for the plaster claims in the context of complex corporate mergers and acquisitions, as well as cancellation of insurance and purchase of new insurance.

Here, the Court of Appeals acknowledges that the "closest" case on the principal unsettled coverage issue is one which tracks precisely with Liberty's coverage analysis. (A-23-24 [discussing *Whittaker v. Allianz Ins. Co., supra*].) That Liberty was "close" but (according to the Court's prognostication of how the California Supreme Court *will rule in the future*) guessed wrong cannot be deemed so reprehensible as to justify a multi-million dollar *punitive* damages award.

2. No "Pattern" of Misconduct Was Shown

In cases, unlike the present one, where a pattern or general practice of misconduct is shown, a reasonable award of punitive damages may be imposed to deter future similar harm to the insured or others. (*Cf., Pacific Mutual Life Ins. Co. v. Haslip, supra,* 499 U.S. at 14.)

Here, no pattern or general practice of misconduct was alleged or proven by Chemstar. Quite the contrary, if the jury had been allowed to hear all facts relevant to Liberty's conduct, the jury would have known that Liberty was defending and paying plaster claims underlying this very dispute. In addition to Liberty's position that Chemstar was not its insured, declination of the Friedman claim arose from factual circumstances applicable to the Friedman claim itself, *i.e.*, that it arose following the expiration of Liberty's policies; that all Liberty coverage was *cancelled* when Chemstar took over; and that the property damage to the Friedman house happened during Chemstar's own insurer's policy period. (*Whittaker v. Allianz, supra.*)

3. Liberty Could Not Have Profited From its Coverage Decision

Profitability of the defendant's wrongful conduct is relevant to the reasonableness of punitive damages. (*See, Pacific Mutual Life Ins. Co. v. Haslip,* 499 U.S. at 22.)

In this case, although Chemstar *asserted* at trial that Liberty made its coverage decision regarding the Friedman claim to avoid Liberty's having to pay many millions of dollars in plaster claims, in fact, *Liberty* as a company would not have had to pay for all the Friedman claim. This is because the Liberty policies collect premiums *retrospectively* (*i.e.*, the insured later pays premiums to Liberty essentially reimbursing it for sums Liberty paid out on the insured's behalf for defense and indemnity of claims). Liberty was *precluded,* however, from informing the jury about the retrospective nature of premiums

because the trial judge believed this to be more relevant to "coverage" issues to be heard later in Phase II. Punitive damages of $14 million where the insurer would not profit from its coverage decision, especially where the jury was prevented from hearing Liberty's side of the story on profitability of the conduct, is unreasonable and violates due process under the Fourteenth Amendment.

4. The Jury Was Precluded From Considering All Relevant Facts

This Court has emphasized that in assessing "reasonableness" of punitive damages under the due process clause of the Fourteenth Amendment, consideration must be given to the full panoply of facts unique to the case at hand, even though comparisons to other cases are difficult. (*TXO Production Corp., supra,* 113 S.Ct. at 2720.) Here, scrutiny of the facts peculiar to this case, and scrutiny of the facts of this case as compared to other cases where punitive damages have been approved by this Court, demonstrate that the award here is "unreasonable" and in violation of due process.

First, unlike the *Haslip* case, where punitive damages arose in a context of conduct proven *fraudulent,* and unlike the *TXO* case, where punitive damages were approved arising from the defendant's having engaged in a form of *slander,* this case awards punitive damages in a species of contract dispute in a complex business scenario.

In what is essentially a business dispute arising from differing interpretations of coverage provisions in an insurance contract and application of unsettled state law to those provisions, lacking any underlying injury to persons, and especially where valid state case law favors the insurer's position on the unsettled legal issue, $14 million in punitive damages have been "unreasonably" imposed.

Second, as set forth in Argument I above, crucial evidence regarding the factual context of this case was kept from the jury's consideration as a result of the trial court's bizarre, backwards bifurcation of this case. The jury was precluded from hearing: 1) the facts regarding other insurers' declinations of coverage; 2) the existence of other plaster damage claims *within* Liberty's policy periods which Liberty *did* defend; 3) evidence regarding exhaustion or near exhaustion of Liberty's policy limits as a result of defending and paying other plaster damage claims; and 4) evidence of Liberty's retrospective premiums showing that *Liberty* would not suffer a "big hit" by its declination of coverage regarding one later plaster damage claim. All of those matters are properly part of the factual context bearing on this insurer's culpability and bearing on the propriety of punitive damages.

Because revelation of all those pertinent facts have a direct effect of exonerating Liberty from breach of the implied covenant of good faith and fair dealing and exonerating Liberty from some or all punitive damages, the multi-million dollar award here was unreasonably imposed in violation of Liberty's Fourteenth Amendment rights.

C. Neither The District Court Nor the Court of Appeals Meaningfully Reviewed the "Reasonableness" of the $14 Million Punitive Award

"Searching" post-trial review of an award of punitive damages is constitutionally mandated. (*See, TXO Production Corp. v. Alliance Resources Corp., supra,* 113 S.Ct. at 2724; *Id.* at 2732 (O'Connor, J., dissenting); *Pacific Mutual Life Ins. Co. v. Haslip, supra,* 499 U.S. at 20-22.) Thoughtful

and meaningful review of punitive damages by an appellate court is a fundamental element of due process. (*Honda Motor Co. v. Oberg*, 114 S.Ct. 2331, 2335, 2340-42 (1994).)

The Ninth Circuit Court of Appeals has ruled that the "due process clause is a federal constitutional standard to be applied to federal as well as state punitive damages awards." (*Morgan v. Woessner*, 997 F.2d 1244 (9th Cir. 1993) [*remanding* case to district court for *analysis* according to *Hammond* factors[15] or other general elements of reasonableness].)

Far from any searching review of the amount or basis of punitive damages, the trial court simply denied

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[15] The *Hammond* factors arise from *Hammond v. City of Gadsden*, 493 So.2d 1374, 1379 (Ala. 1986) approved in this Court's *Haslip* decision. The factors as described by this Court are:

> (a) whether there is a reasonable relationship between the punitive damages award and the harm likely to result from the defendant's conduct as well as the harm that actually occurred; (b) the degree of reprehensibility of the defendant's conduct, duration of that conduct, the defendant's awareness, any concealment, and the existence and frequency of similar past conduct; (c) the profitability to the defendant of the wrongful conduct and the desirability of removing that profit and of having the defendant also sustain a loss; (d) the 'financial position' of the defendant; (e) all the costs of litigation; (f) the imposition of criminal sanctions on the defendant for its conduct, these to be taken in mitigation; and (g) the existence of other civil awards against the defendant for the same conduct, these also to be taken in mitigation. (*Haslip*, 499 U.S. at 21-22.)

Liberty's post-trial motions regarding improper imposition of liability for "bad faith" and punitive damages.[16]

Again, on appeal, following extensive briefing by both Liberty and Chemstar on the existence of "bad faith" and the wrongful imposition of punitive damages, the appellate court's treatment of these issues in its unpublished Memorandum is merely cursory, and contradictory as well.

For example, the Court of Appeals stated that there is valid, otherwise applicable authority for the proposition that Liberty could not be liable for "bad faith," but the Court of Appeals chose not to follow it. (A-29 [refusing to follow *State Farm Mutual Automobile Ins. Co. v. Longden*, 242 Cal.Rptr. 726, 731 (1987)].) The Court of Appeals affirmatively stated there is authority *supporting* Liberty's coverage position in this case (A-24 [*Whittaker v. Allianz Insurance Co.*, 11 Cal.App.4th 1236, 14 Cal.Rptr.2d 659 (1992)]), but the Court chose not to apply it.

On the crucial question of the propriety of the imposition of $14 million in punitive damages against Liberty, extensively briefed by the parties, the Court of Appeals in its "Memorandum" essentially states that the jury could have "inferred" that Liberty acted fraudulently (though there was absolutely no fraud claim asserted against Liberty) and the jury could have inferred Liberty acted "in disregard" of Chemstar's rights. (A-39-40.)[17]

These cursory statements and the cursory treatment of *the conduct* adjudged to warrant millions in punitive damages by the trial court and the appellate court do not

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[16] The trial judge did state his opinion to the effect that this case was an egregious example of an insurer's breach of the implied covenant of good faith and fair dealing.

[17] In two paragraphs, the Ninth Circuit panel noted that the amount of punitive damages was commensurate with Liberty's wealth and that other cases had approved large ratios of compensatory as compared to punitive damages.

amount to meaningful or searching analysis required by due process when a litigant in a civil action – essentially involving a contract interpretation – finds itself liable to the plaintiff for $14 million as punishment for a coverage decision for which there is support under state law and which ultimately may be *correct*, depending upon the outcome of cases presently pending in the State Supreme Court.

Liberty urges this Court to grant certiorari to guide the federal courts in applying standards to achieve a meaningful and adequate post-trial review in contract cases such as this where tort damages may apply and hence punitive damages may attach. Particularly where the punitive damages amount to millions of dollars and where the underlying conduct arises from a breach of an implied covenant of good faith and fair dealing in a business context, standards are needed to which the District Courts and Federal Appeals Courts must adhere to afford defendants meaningful and adequate review of such damages if they have been imposed.

CONCLUSION

Liberty Mutual Insurance Company respectfully urges this Court to grant its Petition for Certiorari.

Respectfully submitted,

DATED: February 3, 1995

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No. _____

In The

Supreme Court of the United States

October Term, 1994

LIBERTY MUTUAL INSURANCE COMPANY,

Petitioner,

v.

CHEMSTAR, INC. AND NATIONAL UNION FIRE INSURANCE CO. OF PITTSBURGH, PA.,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals, Ninth Circuit

PETITION FOR WRIT OF CERTIORARI APPENDIX

APPENDIX

A. Opinions, Orders, Findings of Fact, and Conclusions of Law Delivered Upon the Rendering of the Judgment Upon Which Review is Sought

1. Opinion of the Court of Appeals for the Ninth Circuit, Filed on November 16, 1994. ..... 1a

2. Memorandum Disposition of Phase I Issues, Filed on November 16, 1994..... 26a

3. Memorandum Disposition of Certain Phase II Issues Not Discussed in the Published Opinion, Filed on November 16, 1994. ..... 42a

B. Other Relevant Opinions, Orders, Findings of Fact, and Conclusions of Law Rendered by Courts in This Case

1. Pages 76-81 of the Hearing Transcript from the July 22, 1991 Status Conference Containing the Order Bifurcating the Duty to Defend Issues from the Remainder of the Case..... 50a

2. Minute Order Regarding Bifurcation of Duty to Defend Issues, Dated July 22, 1991. ..... 57a

3. Minute Order Regarding Chemstar's Motion for Summary Judgment on Liability Issues, Dated August 2, 1991..... 59a

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5. Minute Order Regarding Motion to Reconsider the Order on Chemstar's Motion for Summary Judgment, Dated December 23, 1991. ..... 66a

6. Phase I Final Judgment on Special Jury Verdict, Entered on February 13, 1992. ..... 68a

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8. Pages 19-25 of the Hearing Transcript from the March 16, 1992 Hearing on Motions Containing the Order Denying Motion for Judgment as a Matter of Law. ... 84a

9. Order Regarding Cross-defendant National Union's Motion for Summary Judgment, Entered on September 22, 1992. ... 89a

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11. Coverage Chart from Appellee's Opening Brief Regarding Phase II Issues in the Ninth Circuit; Corporate Change Chart from Appellant's Opening Brief Regarding Phase I Issues in the Ninth Circuit.... 106a

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FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

CHEMSTAR, INC., *Plaintiff-Appellee,* v. LIBERTY MUTUAL INSURANCE COMPANY, *Defendant-Appellant,* and GENSTAR CORPORATION; NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA.; INDUSTRIAL INSURANCE COMPANY OF HAWAII, LTD.; AMERICAN HOME ASSURANCE COMPANY; EMPLOYERS INSURANCE OF WAUSAU; UNITED INSURANCE, *Defendants.*	No. 93-55555 D.C. No. CV-90-02904-HLH OPINION
CHEMSTAR, INC., *Plaintiff-Appellant,* v. LIBERTY MUTUAL INSURANCE CO.; GENSTAR CORPORATION; NATIONAL UNION FIRE INSURANCE COMPANY OF	No. 93-55557 D.C. No. CV-90-02904-HLH

PITTSBURGH, PA.; INDUSTRIAL INSURANCE COMPANY OF HAWAII, LTD.; AMERICAN HOME ASSURANCE COMPANY; EMPLOYERS INSURANCE OF WAUSAU; UNITED INSURANCE,

Defendants-Appellees.

CHEMSTAR, INC.,

Plaintiff-Appellee,

v.

LIBERTY MUTUAL INSURANCE CO.; GENSTAR CORPORATION; NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA.; INDUSTRIAL INSURANCE COMPANY OF HAWAII, LTD.; AMERICAN HOME ASSURANCE COMPANY; EMPLOYERS INSURANCE OF WAUSAU,

Defendants,

and

UNITED INSURANCE,

Defendant-Appellant.

No. 93-55558

D.C. No. CV-90-02904-HLH

CHEMSTAR, INC., *Plaintiff-Appellee.* v. LIBERTY MUTUAL INSURANCE CO.; GENSTAR CORPORATION; NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA.; INDUSTRIAL INSURANCE COMPANY OF HAWAII, LTD.; AMERICAN HOME ASSURANCE COMPANY; UNITED INSURANCE, *Defendants,* and EMPLOYERS INSURANCE OF WAUSAU, *Defendant-Appellant.*	No. 93-55560 D.C. No. CV-90-02904-HLH

CHEMSTAR, INC., *Plaintiff-Appellee,* v. LIBERTY MUTUAL INSURANCE CO.; GENSTAR CORPORATION; NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA.; INDUSTRIAL INSURANCE COMPANY OF HAWAII, LTD.; EMPLOYERS INSURANCE OF WAUSAU; UNITED INSURANCE, *Defendants,*	No. 93-55561 D.C. No. CV-90-02904-HLH

AND

AMERICAN HOME ASSURANCE COMPANY,

Defendant-Appellant.

Appeal from the United States District Court
for the Central District of California
Harry L. Hupp, District Judge, Presiding

Argued and Submitted
March 7, 1994 – Pasadena, California

Filed November 16, 1994

Before: Diarmuid F. O'Scannlain, Ferdinand F. Fernandez, and Thomas G. Nelson, Circuit Judges.

Opinion by Judge O'Scannlain

SUMMARY

Insurance/Liability/Third Party

The court of appeals affirmed a district court order. The court held that plaster pitting that occurred in 28 homes as a result of a lime supplier's predecessor's failure to warn recipients regarding its use, constituted one "occurrence" within the meaning of the supplier's liability policy, and the insurer on the risk at the time of the first manifestation of pitting damage was liable for pitting losses at all 28 homes.

Appellee Chemstar, Inc. is a supplier of lime plaster. Chemstar's predessor, Gemstar Lime Co. (GLC), sold lime containing periclase. Lime that contains unhydrated periclase is unfit for home interior use because hydrating

periclase may cause pits in plaster. When GLC sold high-periclase lime from 1984 to 1986, it wrote on bills of lading that the lime was "for exterior use only." It did not inscribe this warning on bags containing the lime however. Consequently, subsequent recipients of the lime did not necessarily receive notice.

Contractors used high-periclase lime in the interiors of homes, causing plaster pitting in at least 28 homes. The 28 homeowners brought claims against GLC and Chemstar between 1985 and 1988.

Chemstar turned to its liability insurers for indemnity and defense of the homeowners' claims. Appellant Liberty Mutual Insurance Co.'s 1985-86 policy covered property damage resulting from an "occurrence" within the policy period. Chemstar filed a complaint asserting a claim against Liberty and other insurers seeking a declaration of its rights to coverage. The insurers filed various counter- and cross-claims. The district court allocated among Chemstar's insurers Chemstar's property damages and defense costs.

The district court issued a partial summary judgment order, ruling that all 28 plaster pitting claims arose from one occurrence and had occurred when pitting manifested in the first home. The court found that plaster pitting first manifested during the 1985-86 policy year. The court allocated pitting damage at all 28 homes to the March 15, 1985 – March 15, 1986 policy period. The court determined that pitting at all 28 homes constituted one, progressive loss. The court held that the underlying cause of the pitting was GLC's failure to warn end-users that

high-periclase lime was unsuitable for indoor use. Chemstar, Liberty, United Insurance Co., American Home Assurance Co., and Employers Insurance of Wausau appealed various portions of the district court's summary judgment order.

[1] There was no intervening, proximate cause of the pitting after GLC's failure to warn. [2] The fact that the 28 incidents of pitting involved different homes, claimants, sources of lime, and times did not preclude a finding that the incidents arose from the same underlying cause. [3] No intervening business decisions occurred between Chemstar's failure to warn and the pitting. [4] The plaster pitting stemmed from a common "occurrence."

[5] It appeared most likely that the California Supreme Court would adopt a "manifestation trigger" for the third party insurance claims involved in this case. [6] Thus, the district court correctly selected a manifestation trigger to determine when the plaster pitting damage occurred. [7] The district court's finding that the pitting first manifested between March 15, 1985 and March 15, 1986 was not clearly erroneous.

[8] California provides that, once property damage manifests within a policy period, the insurer is solely liable for that damage, even if it progresses after the policy lapses. [9] Applying the progressive loss rule in a multi-location context avoids creating a gap in insurance coverage. [10] Further, applying the progressive loss rule in these circumstances would not subvert the purpose of the manifestation trigger, which is to enable insurers to ascertain their liabilities at the end of a coverage period.

COUNSEL

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OPINION

O'SCANNLAIN, Circuit Judge:

We consider unresolved issues of California insurance law to decide what constitutes an "occurrence" under a third-party insurance contract and when such coverage is triggered among successive policy years.

I

Chemstar, Inc. ("Chemstar") is a supplier of lime plaster. Its predecessor, Genstar Lime Company ("GLC")[1] manufactured Type S Hydrate lime, which GLC marketed for use as an interior plaster finish in homes. From 1984 to 1986, GLC sold lime containing high amounts of magnesium oxide pellets, which are called "periclase." During the lime manufacturing process, periclase reacts with water through a process called "hydration" to become magnesium hydroxide, a stable compound. Some periclase may not hydrate, during manufacturing but may later react with moisture in the air until it eventually changes into magnesium hydroxide.

Lime that contains unhydrated periclase is unfit for home interior use. Where such lime is encased in a plastered surface, hydrating periclase may expand and pop through the smooth plaster, causing unsightly pits. Pitting is not inevitable, however, because periclase may never expand. Further, because pitting does not weaken plaster structurally, periclase-laden lime is suitable for exterior use.

When GLC sold high-periclase lime from 1984 to 1986, it wrote on bills of lading that the lime was "for exterior use only." It did not inscribe this warning on

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[1] Genstar Corporation ("Genstar"), a Canadian conglomerate, had as one of its subsidiaries, GLC. On December 5, 1986, Chemstar bought all of GLC's assets from Genstar through a stock purchase agreement. This agreement provided that all of GLC's assets, including insurance policies, were included in the sale. Sometime later, Chemstar and GLC merged into one corporation, Chemstar.

bags containing the lime. Consequently, while GLC's direct purchaser was on notice that high-periclase lime was unsuitable for interior use, subsequent recipients of the lime, who would not have received a GLC bill of lading, did not necessarily receive notice. Given these circumstances, the district court concluded that "it was almost inevitable that some lime with high periclase concentrations would be used indoors." *Chemstar, Inc. v. Liberty Mut. Ins. Co.*, 797 F. Supp. 1541, 1545 (C.D. Cal. 1992).

Contractors did, in fact, use high-periclase lime in the interiors of homes in southern California, causing plaster pitting in at least 28 of these homes. The 28 Homeowners brought claims against GLC and Chemstar between 1985 and 1988.

Chemstar turned to its insurers for indemnity and defense of the homeowners' claims. The policies allegedly covering these losses were all based on a standard comprehensive general liability policy and contain essentially the same terms. The 1985-86 policy of defendant Liberty Mutual Insurance Co. ("Liberty") is typical. It states that Liberty:

> [will] pay on behalf of the Insured all sums which the insured shall become obligated to pay by reason of the liability imposed on the insured . . . [f]or damages because of . . . destruction of tangible property during the policy period . . . , caused by an occurrence.

Chemstar filed a complaint asserting a claim against Liberty and other insurers seeking, among other things, a declaration of its rights to coverage. The insurers, in turn, filed various counter- and cross-claims. The district court bifurcated this action into two proceedings, Phases I and

II. In Phase II, the subject of this appeal, the district court allocated among Chemstar's insurers Chemstar's property damage and defense costs.[2]

On July 23, 1992, the district court issued a partial summary judgment order, ruling that all 28 plaster pitting claims arose from one occurrence and had occurred when plaster pitting manifested in the first home. After a later two-day bench trial, the district court found that plaster pitting first manifested during the 1985-86 policy year. On March 10, 1993, the district court entered its Phase II Declaratory Judgment Order, incorporating its previous dispositive orders and factual findings.

Chemstar, Liberty, United Insurance Company ("United"), American Home Assurance Company ("American") and Employers Insurance of Wausau ("Wausau") appeal various portions of the district court's July 23, 1992 summary judgment order.

II

Except as noted below, California law governs this diversity action. *Intel Corp. v. Hartford Acc. & Indem. Co.*, 952 F.2d 1551, 1555 (9th Cir. 1991). The panel applies

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[2] In Phase I, the district court entered judgment in favor of Chemstar on Chemstar's claim against Liberty for failure to defend. The case proceeded to trial, and the jury found that Liberty had acted in bad faith. We have disposed of Liberty's appeal of this judgment in a separate memorandum disposition filed concurrently with this opinion.

Issues raised in the Phase II appeal not discussed in this opinion are disposed of in a second separate memorandum disposition filed concurrently with this opinion.

California law as it believes the California Supreme Court would apply it. *Id.* Although California appellate court decisions are persuasive precedent, the panel is not bound by them if it believes that the California Supreme Court would decide otherwise. *Hancock Labs., Inc. v. Admiral Ins. Co.*, 777 F.2d 520, 525 n.10 (9th Cir. 1985).

The district court allocated pitting damage at all 28 homes to the March 15, 1985 – March 15, 1986 policy period. It based this decision on three determinations: (1) plaster pitting at all 28 homes arose from one occurrence; (2) plaster pitting occurred at the time that it first manifested, which was during the March 15, 1985 – March 15, 1986 coverage year; and (3) plaster pitting at all 28 homes constituted one, progressive loss. We examine each of these three determinations.

A

Chemstar's insurance policies cover property damage arising from an "occurrence." *See Whittaker Corp. v. Allianz Underwriters, Inc.*, 14 Cal. Rptr. 2d 659, 663 (Cal. App. 1992). The district court held that the underlying cause of the plaster pitting was GLC's failure to warn end-users that high-periclase lime was unsuitable for indoor use. *Chemstar*, 797 F. Supp. at 1547. According to the district court, this failure to warn stemmed from an inadequate quality control system at GLC. *Id.* at 1545, 1548 n.12.

Wausau argues that pitting at the 28 homes did not result from a single cause but, instead, arose from a combination of distinct causes. Because plaster pitting was not inevitable in every home in which high-periclase

lime was installed, Wausau asserts that pitting resulted from circumstances unique to each home rather than an underlying failure to warn.

The district court rejected this argument. Declining to individuate causes of the pitting at each home, it stated that GLC's:

> failure to warn was a continuing cause that was not interrupted by any other cause. As noted before, if GLC had employed an adequate quality control system and warned of the proper uses of its product, the other causes offered by American, Wausau, and United would not have resulted in property damage.

Id.

[1] We agree with the district court that there was no intervening, proximate cause after GLC's failure to warn. In *Mead Reinsurance v. Granite State Insurance Co.*, 873 F.2d 1185, 1187 (9th Cir. 1989), a municipality (the "City") had been sued in twelve separate section 1983 lawsuits, and the City looked to its primary and excess insurers for indemnity. The City and primary insurer argued that eleven of these twelve suits stemmed from only one occurrence because, in these cases, the City's liability was premised upon a single police policy condoning excessive police force. *Id.* at 1187. The excess insurer argued that the eleven actions involved different occurrences because the allegations of the complaints involved different police actions, different injuries, and different classes of plaintiffs. *Id.*

The district court entered summary judgment against the excess insurer. It found that the eleven section 1983

complaints alleged the same excessive force policy and were premised upon the City's deliberate indifference to excessive force by its police department. Finding the differences in the allegations of the complaints to be irrelevant, the district court concluded that, under California law, the eleven claims arose from the same occurrence. This court affirmed. *Id.* at 1187-88.

[2] While we are concerned that *Mead* failed to cite any California authority for its decision, we acknowledge that it supports the district court's conclusion as to the proximate cause of the plaster pitting.[3] As in *Mead*, the fact that the 28 incidents of pitting involved different homes, claimants, sources of lime, and times does not preclude a finding that the incidents arose from the same underlying cause. Although Wausau argues that it was not inevitable that pitting would occur despite Chemstar's failure to warn, the same principle is true for *Mead:* the use of excessive force was not inevitable, despite a policy condoning it, in every instance of police conduct;

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[3] A recent California appellate case, *State Farm Fire & Cas. Co. v. Elizabeth N.*, 12 Cal. Rptr. 2d 327 (Cal. App. 1992), suggests a result contrary to that in *Mead*. In *Elizabeth N.*, several children were molested, each on multiple occasions, at a day care center. Although the district court of appeal held that the multiple molestations that each child suffered constituted one occurrence, *id.* at 329-30, the court viewed the injury of each child to be distinct from the injuries to the other children, such that the injury of each child constituted a separate occurrence. However, because the parties in *Elizabeth N.* had stipulated that each child's injuries were distinct, it is unclear whether this view is controlling. Under the circumstances, we do not believe that we are free to depart from the clear circuit precedent established in *Mead*.

instead, the use of force presumably depended upon the actions of individual police officers and the circumstances in which force was used.

A case cited by Wausau, *Eureka Fed. Sav. & Loan Ass'n v. American Cas. Co. of Reading, Pennsylvania*, 873 F.2d 229 (9th Cir. 1989), is distinguishable from this action. In *Eureka*, Eureka Savings & Loan Association ("Eureka") and two of its former officers sought a declaratory judgment that an insurer's directors and officers liability policy covered losses that Eureka incurred in over 200 loan transactions. The insurer argued that losses from the 200 transactions constituted a single loss because they resulted from an "aggressive lending strategy." *Id.* at 234. The district court rejected this contention, treating each transaction as a separate loss. We affirmed, stating:

> [T]he fact that all loan losses arguably originated from one loan policy does not require finding only one loss. In this case there were numerous *intervening business decisions* that took place only after the loan policy was initiated that required the exercise of independent judgment.

Id. at 234-35 (underscore added). The court added that it "d[id] not foreclose the possibility . . . that . . . separate borrowers may be aggregated as a single loss in an appropriate fact situation." *Id.* at 235.

[3] Unlike the loan transactions in *Eureka*, no intervening business decisions occurred between Chemstar's failure to warn and the pitting. Rather, it qualifies as "an appropriate fact situation" in which distinct losses arise from one occurrence. We thus conclude that *Mead*, rather than *Eureka*, governs this case.

B

[4] Having determined that the plaster pitting stemmed from a common "occurrence," we consider when the plaster pitting occurred. Chemstar's insurance policies only cover property damage that results from an occurrence within the respective policy periods.

1

Adopting a "manifestation" trigger of coverage, the district court held that plaster pitting occurred at the first date that it became reasonably apparent or appreciable to homeowners. *Chemstar,* 797 F.Supp. at 1551-52. Chemstar, United, and Wausau assert that the district court should have applied a "continuous trigger" of coverage to determine which insurers were on the risk at the time of the plaster pitting. Under a continuous trigger, an insurer must cover damage that either begins or progresses during its policy period. Antognini, "A Prophecy from the Wilderness: The California Supreme Court and the Trigger of Coverage." *5 Cal. Ins. Law & Reg. Rptr.* 196, 204 (1993) ("Prophecy"). Had the district court adopted a continuous trigger, property damage would not have been limited to the 1985-86 policy year but, instead, likely would have been spread out over several years, triggering coverage under several policies.

In *Hancock Laboratories, Inc. v. Admiral Insurance Co.,* 777 F.2d 520 (9th Cir. 1985), a case decided under California law, we explicitly rejected both the manifestation and continuous triggers in favor of an "exposure" trigger, which none of the parties in this appeal advocate. Since *Hancock,* however, several California courts have selected

a manifestation trigger. In *Prudential-LMI Commercial Insurance v. Superior Court of San Diego County*, 274 Cal. Rptr. 387 (1990), the California Supreme court adopted a manifestation trigger for first party insurance. In that case, a homeowner looked to its insurers to cover an extensive crack in an apartment unit's foundation. The crack had been caused by gradual soil expansion which could have occurred over several policy periods. A district court of appeal held that the property damage should have been apportioned to all insurers whose policies covered the period in which the crack had developed.

The supreme court rejected the intermediate appellate court's approach and adopted a manifestation trigger for two reasons. First, the supreme court believed that "the underwriting practices of the insurer can be made predictable because the insurer is not liable for a loss once its contract with the insured ends unless the manifestation occurred during its contract term." *Id.* at 404. This increased predictability leads to reduced insurance premiums "because insurers will be able to set aside proper reserves for well-defined coverage and avoid increasing such reserves to cover potential financial losses caused by uncertainty in the definition of coverage." *Id.* at 403. Second, the supreme court believed that the manifestation trigger met the reasonable expectations of insureds, who "look to their present carrier for coverage" of losses. *Id.* at 404.

The court expressly limited its decision to first party insurance. Concerned "that there are substantial analytical differences between first party property policies and third party liability policies," it declined to identify the

appropriate trigger for third party liability insurance, leaving that question open for subsequent resolution. *Id.* at 389, 403.

Subsequent decisions by California appellate courts have applied a manifestation trigger to third party insurance. For example, in *Pines of La Jolla Homeowners Association v. Industrial Indemnity,* 7 Cal.Rptr. 2d 53 (Cal. App. 1992), the insureds were responsible for construction of a condominium complex. After a multitude of construction defects appeared, the condominium homeowners association sued the insureds, who then sought indemnity from their insurers. Another district court of appeal recently held that a manifestation trigger determined in which policy periods the defects occurred. *Id.* at 57. *Tomaselli v. Transamerica Ins. Co.,* 31 Cal. Rptr. 2d 433 (Cal. App. 1994).[4]

[5] Given the changed state of California law, it appears most likely that the California Supreme Court

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[4] In three other cases, California appellate courts have rejected the manifestation trigger in favor of a continuous trigger. *See Armstrong World Inds., Inc. v. Aetna Cas. & Sur. Co.,* 26 Cal. Rptr. 2d 35 (Cal. App. 1993), *review granted,* 27 Cal. Rptr. 2d 488 (1994); *Montrose Chem. Corp. v. Admiral Ins. Co.,* 5 Cal. Rptr. 2d 358 (Cal. App.), *review granted,* 24 Cal. Rptr. 2d 661 (1992); *Stonewall Ins. Co. v. City of Palos Verdes Estates,* 9 Cal. Rptr. 2d 663 (Cal. App.), *review granted,* 11 Cal. Rptr. 2d 329 (1992). However, because the supreme court has granted review of these three decisions, they no longer are precedent. Cal. R. Ct. 976(d), 977. Another appellate decision, *California Union Ins. Co. v. Landmark Ins. Co.,* 193 Cal. Rptr. 461 (Cal. App. 1983), also adopted the continuous trigger for third party insurance claims. The *Hancock* court specifically considered and rejected *California Union,* however. *Hancock,* 777 F.2d at 525 n.10.

would adopt a manifestation trigger for the third party insurance claims involved in this case. The first, and most obvious, reason for this conclusion is that post-*Hancock* California precedent has chosen a manifestation trigger. Although not determinative, this fact weighs strongly in favor of abandoning *Hancock* and adopting a manifestation trigger. *See Houston Gen. Ins. Co. v. AG Production Co. & Chemurgic Agric. Chems., Inc.*, 840 F. Supp. 738, 742 n.1 (E.D. Cal. 1993).

Second, the supreme court's reasons for adopting a manifestation trigger for first party insurance in *Prudential* equally favor a manifestation trigger in this case. As in first party insurance, a manifestation trigger presumably will promote certainty in the third party insurance industry because an insurer can be confident that it will not be liable for a loss once its policy period has ended and no loss has manifested. *See* Antognini, "Prophecy," 5 *Cal. Ins. Law & Reg. Rptr.* at 209. This increased certainty should redound to the benefit of insureds, who will pay lower premiums.

Also, a manifestation trigger does not pose a risk of compromising an insured's reasonable expectations of coverage under the facts of this case. Here, the insured already has received coverage for the plaster pitting claims. The court's selection of a trigger of coverage thus will affect only the allocation of coverage among insurers; it will not impact on Chemstar. A manifestation trigger can no more deprive Chemstar of reasonably anticipated coverage than it can upset reasonable expectations in first party insurance. *See Fireman's Fund Ins. Co. v. Aetna Cas. & Sur. Co.*, 273 Cal. Rptr. 431, 434, 435 (Cal. App. 1990).

Chemstar and United argue that a manifestation trigger is inconsistent with Chemstar's insurance policies because the policies nowhere limit coverage to property damage that "manifests," becomes discoverable, or starts during a policy period. *See TBG, Inc. v. Commercial Union Ins. Co.*, 806 F. Supp. 1444, 1453 (N.D. Cal. 1990). We disagree. At best, the argument raises the possibility that the insurance contracts are ambiguous. California courts appear to have rejected that position, however. Further, underlying the parties' criticism is the view that the manifestation trigger upsets the reasonable expectations of insureds. Yet, in *Prudential*, the California Supreme Court observed that an insured typically looks to its present insurer to cover losses that occur. 274 Cal. Rptr. at 404. The manifestation trigger is consistent with this expectation. Further, even if an insured tends to interpret a third party liability policy in the manner suggested by Chemstar and United, there is no need to defer to that understanding in this case. The "general principle that ambiguities in insurance contracts must be interpreted in favor of coverage is inapplicable where . . . the case concerns only the respective liabilities of two insurers." *Fireman's Fund*, 273 Cal. Rptr. at 435. As noted above, the trigger of coverage will affect only the respective liabilities of Chemstar's insurers because Chemstar already has received full indemnity.[5]

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[5] The parties also raise the question of whether a continuous trigger would violate California's loss in progress rule. Cal. Ins. Code §§ 22, 250. Having selected a manifestation trigger for other reasons, we need not answer this question.

[6] Chemstar and United present no convincing reason to disregard the clear trend of California authority. The district court correctly selected a manifestation trigger to determine when the plaster pitting damage occurred.[6]

2

Applying the manifestation trigger, the district court found that plaster pitting first manifested between March 15, 1985 and March 15, 1986. Liberty and Wausau challenge this factual finding, arguing that plaster pitting first manifested during the 1984-85 policy period. We review for clear error, giving due regard to the district court's superior opportunity to judge the credibility of witnesses. Fed. R. Civ. P. 52(a); *United States v. Helmandollar*, 852 F.2d 498, 501 (9th Cir. 1988); *Wardley Int'l Bank, Inc. v. Nasipit Bay Vessel*, 841 F.2d 259, 261 n.1 (9th Cir. 1988).

[7] The district court's finding was not clearly erroneous. The parties stipulated that pitting had become appreciable before March 15, 1986. Further, there was no dispute that pitting had occurred during the March 15, 1985 – March 15, 1986 policy period. The only disputed fact was whether pitting had occurred *before* this period. Addressing this issue, Liberty presented the testimony of

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[6] National argues that the district court should have adopted an "injury in fact" trigger of coverage, a variant of the manifestation trigger. For the reasons expressed above, we reject it, also.

homeowners and a general contractor to prove that pitting had occurred before March 15, 1985. Chemstar introduced the testimony of plaster installers and inspectors to refute this testimony. Finding the testimony of Liberty's witnesses to be unreliable and inconsistent with other evidence, the court concluded that the preponderance of the evidence showed that pitting had first manifested after, rather than before, March 15, 1985. We see no reason to overturn this credibility assessment.

Liberty and Wausau also complain that the district court wrongly gave them the burden of proving that plaster pitting occurred prior to March 15, 1985. California law places "the burden of proof . . . on . . . the insured . . . to prove that an event is within the scope of coverage." *Whittaker,* 14 Cal. Rptr. 2d at 664.

The district court applied the correct burden of proof. As noted above, the parties already had stipulated that pitting had manifested during the March 15, 1985 – March 15, 1986 policy period. Chemstar thus had met its burden of producing evidence that damage had occurred during the policy period. Although Liberty asserts that it was forced to prove a negative – *i.e.,* that pitting did not first manifest after March 15, 1985, this is not true. The district court simply required Liberty to show (affirmatively) that pitting first manifested before March 15, 1985. In fact, it is Liberty that seeks to impose upon Chemstar the burden of proving a negative: under Liberty's approach, Chemstar would have had to demonstrate, not only that pitting manifested during the 1985-86 policy period, but also that no pitting had manifested before March 15, 1985.

We thus conclude that the district court correctly selected and applied the manifestation trigger.

C

We last consider whether pitting at all homes should be telescoped into the March 15, 1985 – March 15, 1986 period of coverage, even though pitting at some homes first became appreciable after that time. The district court held that, as a matter of law, "all of the homeowners' property damage occurred when the plaster-pitting manifested in the first home, thus triggering coverage only under those policies effective at the time of first manifestation." *Chemstar*, 797 F. Supp. at 1553.

[8] The district court reached its decision by viewing all plaster pitting as one, progressive loss. California provides that, once property damage manifests within a policy period, the insurer is solely liable for that damage, even if it progresses after the policy lapses. *See Pines of La Jolla v. Industrial Indem.*, 7 Cal. Rptr. 2d at 56-57. Progressive loss typically occurs where damage to a single building or property becomes worse over a period of time. *See, e.g., Fireman's Fund*, 273 Cal. Rptr. at 431.

Analogizing to this situation, the district court concluded that there was:

> no basis . . . for distinguishing between cases in which one occurrence gives rise to property damage in one or multiple buildings. On the contrary, it finds good reason to treat both types of cases the same. . . . [F]inding a single trigger in both cases avoids anomalous outcomes. Without the single trigger, courts may, at their whim,

> allocate losses among insurers by drawing arbitrary lines between, say, two condominiums in the same building, two halves of one duplex, a house and a guest house on one property, or two homes on the same street. Such anomalous outcomes . . . expose insurers to greater uncertainty: Although an insurer may escape liability in one court, it has no guarantee that the next court will not hold it liable on similar facts.

Chemstar, 797 F. Supp. at 1552.

The district court added:

> [F]inding a single trigger in both cases protects the insured's access to insurance. In this case, once plaster-pitting manifested in the first home, a potential insurer who is aware of this risk would refuse to insure Chemstar if some courts treated plaster-pitting in a different home arising from the same occurrence as a separate trigger. By contrast, finding a single trigger protects the insurer from such potential liability and makes it willing to insure against *other* property damage arising from future occurrences.

Id. (emphasis added).

California courts have never directly addressed this question. The closest case is *Whittaker Corp. v. Allianz Underwriters, Inc.*, 14 Cal. Rptr. 2d 659 (Cal. App. 1992). In *Whittaker*, the insured ("Whittaker") developed and marketed a sealing compound that beverage can manufacturers used to seal can ends onto can bodies. This sealing compound originally contained an anti-oxident call No-Nox. In 1983, Whittaker switched to another anti-oxident, ACD-50. Whittaker's three customers – American Can

Co., Ball Corp. and Reynolds Metal Co.– later experienced problems with Whittaker's sealing compound, which had permitted leakage from the customers' beverage cans. Whittaker sought indemnity from two insurers under separate 1983 and 1984 policies for claims brought by these customers.

The parties agreed that American Can's claim was "a fiscal year 1983 occurrence" because Whittaker had sold the compound to American Can in 1983 and the damage had occurred in 1983. There thus was no dispute that American Can's claim was covered by the 1983 insurance policy. The court found, however, that neither Ball nor Reynolds had suffered damage from the sealing compound until 1984. It concluded that these claims were not covered by the 1983 policy, even though the American Can loss had manifested during the 1983 coverage period.

Whittaker can be read to support the view that property damage which arises from the same occurrence but which occurs at different locations does not constitute one, progressive loss. However, the *Whittaker* court never directly addressed this point; instead, it framed the issue before it as whether a claim arises at the time of the act that causes property damage or the time of the manifestation of the damage. *Id.* at 662. We thus are reluctant to interpret *Whittaker* as a definitive statement of California law on the precise question before this court.

[9] Given this, we find the district court's reasoning to be persuasive. In addition to avoiding arbitrary distinctions, applying the progressive loss rule in a multi-location context avoids creating a gap in insurance coverage. Once property damage at one building manifests,

wary insurers may become unwilling to insure for such damage in future policy periods out of fear that the damage will manifest at other buildings. There thus is a risk that insureds will become unable to obtain insurance coverage for these anticipated losses. *See* K. Abraham, *Distributing Risk* 159 (1986).

[10] Further, applying the progressive loss rule in these circumstances will not subvert the purpose of the manifestation trigger, which is to enable insurers to ascertain their liabilities at the end of a coverage period. *See Prudential-LMI,* 274 Cal. Rptr. at 403-04. Just as other insurers can foresee the possibility of future losses arising from a single occurrence which already has manifested one injury, so too can one's present insurer. Consequently, once damage manifests at one location during a policy period, an insurer is on notice of the risk of damage occurring at other locations. It thus has ample opportunity to investigate the extent of its possible exposure and to adjust its insurance reserves accordingly.

III

We conclude that the district court did not err in entering its July 23, 1992 summary judgment. It properly found that there was one occurrence and that the insurer on the risk a the time of the first manifestation of pitting damage was liable for pitting losses at all 28 homes. Accordingly, the March 10, 1993 final order incorporating that judgment is

AFFIRMED.

NOT FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

CHEMSTAR, INC., Plaintiff-Appellee, v. LIBERTY MUTUAL INSURANCE COMPANY, Defendant-Appellant, and GENSTAR CORPORATION; NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA.; INDUSTRIAL INSURANCE COMPANY OF HAWAII, LTD.; AMERICAN HOME ASSURANCE COMPANY; EMPLOYERS INSURANCE OF WAUSAU, Defendants.	No. 92-55472 D.C. No. CV-90-2904-HLH **MEMORANDUM*** (Filed Nov. 16, 1994)

Appeal from the United States District Court
for the Central District of California
Harry L. Hupp, District Judge, Presiding

Argued and Submitted March 7, 1994
Pasadena, California

*This disposition is not appropriate for publication and may not be cited to or by the courts of this circuit except as provided by Ninth Circuit Rule 36-3.

Before: **O'SCANNLAIN, FERNANDEZ,** and **T.G. NELSON,** Circuit Judges.

In this appeal of Phase I of this case, Liberty Mutual Insurance Company ("Liberty") argues that the district court erred in granting summary judgment in favor of Chemstar, Inc., ("Chemstar") on the issues of Liberty's duty to defend and the sufficiency of the evidence in support of the jury's finding that Liberty acted in bad faith when it breached this duty. Liberty also contests the award of compensatory and punitive damages.[1]

I

Liberty argues that the district court erred in holding that Liberty had no duty to defend because the policy covered only Genstar Lime Company, Inc. ("GLC"), the company Chemstar purchased. Our review of the record, however, discloses substantial evidence supporting the district court's conclusion that the policy transferred to Chemstar with the purchase. The stock purchase agreement between Chemstar and GLC's former owner, Genstar Lime, transferred all of GLC's assets, including insurance contracts, to Chemstar. Therefore, we hold that Chemstar was entitled to a defense under GLC's policy.[2]

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[1] Issues relating to the appeal of Phase II of this case are addressed in a separate opinion and a separate memorandum disposition, both of which are filed concurrently herewith.

[2] Both parties cite *Northern Insurance Co. of New York v. Allied Mutual Insurance Co.*, 955 F.2d 1353 (9th Cir.), *cert. denied*, 112 S. Ct. 3033 (1992). However, *Northern Insurance* has recently received sharp criticism from a California district court of appeal. *See Quemetco, Inc. v. Pacific Automobile Ins. Co.*, 29 Cal.

II

Liberty argues that even if Chemstar could claim benefits under GLC's policy, Liberty had no duty to defend suits based on claims filed after December 5, 1986, the date Chemstar terminated Liberty's coverage.

"An insurer . . . bears a duty to defend its insured whenever it ascertains facts which give rise to the potential of liability under the policy." *Gray v. Zurich Ins. Co.*, 419 P.2d 168, 177 (Cal. 1966). "Implicit in this rule is the principle that the duty to defend is broader than the duty to indemnify; an insurer may owe a duty to defend its insured in an action in which no damages ultimately are awarded." *Horace Mann Ins. Co. v. Barbara B.*, 846 P.2d 792, 795 (Cal. 1993). "Any doubt as to whether the facts give rise to a duty to defend is resolved in the insured's favor." *Id.* at 796.

In *Montrose Chemical Corp. of California v. Superior Court*, 861 P.2d 1153 (Cal. 1993), the California Supreme Court explained the burdens on the parties seeking summary judgment of the duty to defend issue:

> To prevail, the insured must prove the existence of a *potential for coverage*, while the insurer must establish *the absence of any such potential*. In other words, the insured need only show that the underlying claim *may* fall within policy coverage; the insurer must prove it *cannot*. Facts merely tending to show that the claim is not covered, or may not be covered, but are insufficient to eliminate the possibility that resultant damages (or the nature of the action) will fall

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Rptr. 2d 627 (Cal. App. 1994). For this reason, we do not rely on *Northern Insurance* for our holding.

> within the scope of coverage, therefore add no weight to the scales.

Id. at 1161 (emphasis in original).

The district court was correct in concluding that Chemstar had shown a potential for coverage and that Liberty had not established the absence of any such potential. California law is unclear as to (1) what constitutes the occurrence that gives rise to property damage and (2) when property damage occurs such that it triggers coverage in a particular policy period. Under various theories adopted by California courts, policy coverage can be triggered when property is exposed to the cause of the damage, when damage in fact happens, or when damage manifests itself.[3] Thus, depending on the legal interpretation, the policy may or may not have covered all the pitting claims.

Liberty contends that it did not have a duty to defend because the potential for liability rested on a disputed legal question. In *State Farm Mutual Automobile Insurance Co. v. Longden*, 242 Cal. Rptr. 726, 731 (Cal. App. 1987), a California appellate court held that a potential for liability arising from a disputed legal question did not impose upon the insurer a duty to defend.

We decline to follow *Longden*.[4] The California Supreme Court in *Gray* explained that the duty to defend

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[3] *See* accompanying opinion disposing of related issues in Phase II.

[4] In this diversity case, we must determine what the California Supreme Court would rule. *Hancock Labs., Inc. v. Admiral Ins. Co.*, 777 F.2d 520, 525 n.10 (9th Cir. 1985). We are not bound by an intermediate state appellate court ruling. *Id.*

"includes only defense to those actions of the nature and kind covered by the policy." 419 P.2d at 175. Here, the Liberty policy covered property damage to third parties caused by GLC. The facts before the district court indicated that the plaster pitting suits were the type of claims for which Chemstar could reasonably expect protection under its property damage policy. *See Hanson v. Prudential Ins. Co. of Am.*, 783 F.2d 762, 765 (9th Cir. 1985) ("[T]he insurance contract mut be considered in light of the reasonable expectations of the insured at the time he purchased coverage."). Nowhere in *Gray* did the California Supreme Court suggest that disputed legal questions could not give rise to the potential of liability.

Finally, Liberty argues in its reply brief that under the district court's July 1992 decision on Phase II, Liberty had no duty to defend because it had exhausted its $2 million policy limit. We reject this argument. Liberty cannot use a later decision on coverage to dispute the district court's earlier decision on duty to defend. *Horace Mann*, 846 P.2d at 795.

III

Liberty argues that the district court erred in bifurcating the duty to defend and bad faith issues and the indemnity issues.

Federal Rule of Civil Procedure 42(b) allows a district court to order a separate trial of any claim or issue "in furtherance of convenience or to avoid prejudice, or when separate trials will be conducive to expedition and economy." We have upheld a bifurcation order when it "simplified the issues for the jury" and reduced "the danger

of unnecessary jury confusion." *Hirst v. Gertzen*, 676 F.2d 1252, 1261 (9th Cir. 1982). Alternatively, we have reversed such an order when the bifurcated issues were so intertwined that their separation would "tend to create confusion and uncertainty." *Miller v. Fairchild Ind., Inc.*, 885 F.2d 498, 511 (9th Cir. 1989) (quotation omitted), *cert. denied*, 110 S. Ct. 1524 (1990).

Here, bifurcation greatly helped simplify a legally complicated and issue-intensive case and did not separate intertwined issues so as to create confusion and uncertainty. We hold that the district court did not abuse its discretion in ordering bifurcation.

Liberty further maintains that bifurcation prevented it from submitting evidence showing that its policy did not cover the Friedman claim. This argument has no merit. Because Liberty potentially had the duty to indemnify, evidence suggesting that there was no coverage was irrelevant. *Montrose*, 861 P.2d at 1161 ("Facts merely tending to show that the claim is not covered, or may not be covered, but are insufficient to eliminate the possibility that resultant damages (or the nature of the action) will fall within the scope of coverage, . . . add no weight to the scales.").

IV

Liberty challenges the jury's verdict that Liberty breached the policy's implied covenant of good faith and fair dealing when it refused to defend Chemstar.

A

Liberty argues that Chemstar is not a contracting party nor an insured under the policy and therefore is not entitled to sue under the policy's duty of good faith. This argument has no merit. When Chemstar inherited the benefits under the policy as a purchaser of substantially all of GLC's assets, *see Northern Ins. Co. of New York v. Allied Mutual Ins. Co.*, 955 F.2d 1353, 1358 (9th Cir.), *cert. denied*, 112 S. Ct. 3033 (1992), one of these benefits was Liberty's duty to deal in good faith.

The cases Liberty cites are not to the contrary. None support the proposition that the duty of good faith does not transfer by operation of law to a purchaser of substantially all assets. *See Northwestern Mut. Ins. Co. v. Farmers Ins. Group*, 143 Cal. Rptr. 415, 422 (Cal. App. 1978) (*third party beneficiary* may enforce implied covenant that was intended to benefit him); *Gruenberg v. Aetna Ins. Co.*, 510 P.2d 1032, 1039 (Cal. 1973) (*insurer's employees and agents* not liable under policy for duty of good faith); *Murphy v. Allstate Ins. Co.*, 553 P.2d 584, 588 (Cal. 1976) (*injured claimant* cannot enforce covenant of good faith not intended to benefit him); *Austero v. National Cas. Co.*, 133 Cal. Rptr. 107, 110 (Cal. App. 1976) (wife could not enforce duty of good faith under husband's policy because she was not intended beneficiary of benefits which were denied); *Hatchwell v. Blue Shield of Cal.*, 244 Cal. Rptr. 249, 252-52 (Cal. App. 1988) (same).

B

Liberty maintains that since it acted reasonably in deciding that Chemstar was not an insured under the

policy and that some of the claims were not covered by the policy, it did not refuse to defend in bad faith.

"[B]efore an insured can be found to have acted tortiously, *i.e.*, in bad faith, in refusing to bestow policy benefits, it must have done so 'without proper cause.' " *California Shoppers, Inc. v. Royal Globe Ins. Co.*, 221 Cal. Rptr. 171, 200 (Cal. App. 1985); *see also Opsal v. United Services Auto. Ass'n*, 10 Cal. Rptr. 2d 352, 355 (Cal. App. 1991). However, "a mistaken withholding of policy benefits . . . is consistent with observance of the implied covenant of good faith and fair dealing because mistake supplies the 'proper cause.' " *California Shoppers*, 221 Cal. Rptr. at 201. "Refusal to defend, without more, does not constitute a breach of the implied covenant." *Tibbs v. Great Am. Ins. Co.*, 755 F.2d 1370, 1375 (9th Cir. 1985).

Liberty argues that it had proper cause to believe that Chemstar was not an insured. We disagree. There was substantial evidence presented at trial for the jury to determine that Liberty's alleged mistake in considering Chemstar an uninsured was without proper cause.

Nor has Liberty shown that it had proper cause to base its refusal on the lack of coverage of the claims filed after December 5, 1986. Evidence was presented to the jury that Liberty was aware that it had a duty to defend and had potential liability for all the claims. *See id.* at 1375 (insurer acted in bad faith by refusing to defend where it was aware that insured was "probably entitled to a defense").

Liberty also argues that California law was unsettled on when an occurrence gives rise to coverage. It argues that, like the insurers in *Opsal*, 10 Cal. Rptr. at 357, and

Safeco Insurance Co. of America v. Guyton, 692 F.2d 551, 557 (9th Cir. 1982), it based its refusal on a genuine legal issue open to interpretation. We reject this argument because neither case is on point. Both address an insurer's refusal to indemnify, not refusal to defend. Inherent in the concept of the duty to defend is the unresolved issue of coverage. All that is necessary is the *potential* of coverage. If the insurer could justify its refusal to defend on the argument that coverage was not yet decided, the duty to defend would collapse into the duty to indemnify.

C

Liberty claims that the district court did not allow it to introduce evidence showing that it acted in good faith in refusing to defend. "A trial judge has wide latitude in the admission or exclusion of evidence where the question is one of materiality or relevance, . . . and a decision to exclude evidence will not be disturbed unless there has been an abuse of discretion." *Lies v. Farrell Lines, Inc.*, 641 F.2d 765, 773 (9th Cir. 1981) (citation omitted). The Ninth Circuit does "not reverse for evidentiary errors unless refusal to do so would be inconsistent with substantial justice." *Rogers v. Raymark Ind., Inc.*, 922 F.2d 1426, 1429 (9th Cir. 1991).

We conclude that the district court did not err in ruling that evidence on policy limits, retrospective premiums, or excess coverage was not relevant to the duty to defend. Liberty has failed to show that this evidence was relevant or that its exclusion resulted in substantial injustice.

Liberty also argues that the district court erred by excluding evidence on Liberty's state of mind and by admitting evidence of Liberty's promises to homeowners. This argument has no merit because a Liberty employee, Frank Overman, was given a chance to testify about Liberty's considerations in deciding not to defend.

V

Liberty argues that the district court erred in formulating five of its jury instructions: by misstating California law on the duty to defend; by failing to give an honest mistake instruction on the issue of bad faith; by misdefining despicable conduct, one of the elements of punitive damages; by failing to state the necessary causal connection between a breach of good faith and the employment of counsel in the issue of *Brandt* attorneys fees; and by failing to repeat the passion and prejudice instruction when the jury returned for further deliberations on the amount of punitive damages.

Jury instructions are considered as a whole to determine if they are misleading or inadequate. *Oviatt v. Pearce*, 954 F.2d 1470, 1480 (9th Cir. 1992). An error in instructing the jury in a civil case does not require reversal if it more probably than not is harmless. *Caballero v. Concord*, 956 F.2d 204, 206 (9th Cir. 1992). Since Liberty failed to object at trial on the first four grounds, we decline to review the instructions. Fed. R. Civ. P. 51; *Glover v. BIC Corp.*, 6 F.3d 1318, 1326 (9th Cir. 1993) (quotation omitted).

Liberty did object at trial to the district court's failure to give a second passion and prejudice instruction when the jury returned to deliberate on the amount of punitive

damages. We conclude that because the district court had given this instruction when the jury began its first deliberations on whether Liberty was liable for punitive damages, there was no error in its omission before the second deliberations. *Cooper v. Firestone Tire and Rubber Co.*, 945 F.2d 1103, 1106 (9th Cir. 1991) (district court does not abuse its discretion when it does not give redundant instructions). We reject Liberty's contention that the district court's failure to repeat the instruction violated *Pacific Mutual Life Insurance Co. v. Haslip*, 499 U.S. 1 (1991). The Supreme Court in that case did not require an instruction on passion and prejudice.

VI

Liberty argues that the award of compensatory damages was improper.

A

First, Liberty contends that it should not have had to indemnify Chemstar for the amount of the Friedman settlement until the district court determined that the Friedman claim was covered by the policy. We agree.

The California Supreme Court concluded in *Hogan v. Midland National Insurance Co.*, 476 P.2d 825, 833 (Cal. 1970), that an insurer who failed to defend was responsible only for the insured's fees and costs incurred in defense and the damages for claims *covered* by the policy. Under *Hogan*, the district court should have made its finding as to coverage before deciding whether Liberty

was responsible for the settlement. However, in our separate opinion disposing of Phase II issues, we conclude that the district court properly found that the Friedman claim was covered by the Liberty policy. Thus, the district court's mistake in awarding the damages too early was harmless since Liberty would have to pay for the settlement and the accumulated interest in any event.

B

Liberty also maintains that the award for attorneys fees Chemstar incurred to obtain policy benefits after Liberty's breach of good faith was improper. In *Brandt v. Superior Court*, 693 P.2d 796, 798 (Cal. 1985), the California Supreme Court held that "[w]hen an insurer's tortious conduct reasonably compels the insured to retain an attorney to obtain the benefits due under a policy, it follows that the insurer should be liable in a tort action for that expense." The court was careful to note that its holding did not include fees "attributable to the bringing of the bad faith action itself." *Id.*

First, Liberty contends that since coverage had not been determined in Phase I, *Brandt* was inapplicable. We disagree. Since Chemstar was entitled to a defense under the policy, regardless of the ultimate coverage determination, *Brandt* applies to Chemstar's pursuit of this benefit.

Liberty further argues that the district court erred in admitting monthly summaries of the attorneys fees instead of requiring that daily records be introduced. We reject this argument. Since Liberty stipulated to admission at trial, it cannot complain now. In any event, Liberty

introduced the attorneys' billing statements, which provided the jury with a detailed record of the attorneys' work.

Liberty also claims that the district court erred in allowing evidence on fees incurred after April 17, 1991, when Liberty's policy allegedly was exhausted. This admission was not erroneous. *Brandt* fees are tort damages, not payment on claims covered by an insurance policy. Therefore, even when the insured has exhausted the policy limits and no longer must pay out under the policy, it must still pay for damages caused by its torts.

Finally, Liberty contends that there was insufficient evidence under *Brandt* for the jury to decide what part of the fees were related to policy benefits and what part to the bad faith claim. We hold that the attorney billing statements submitted by Liberty and the attorneys' testimony on how they allocated fees between work on policy benefits and work on the bad faith claim was substantial evidence supporting the jury verdict.

C

Liberty argues that the award of prejudgment interest was erroneous. California Civil Code § 3287 provides for the award of prejudgment interest for breach of contract damages. The district court awarded the interest on fees incurred defending against the homeowners' suits and on the Friedman settlement, both breach of contract damages. Therefore, we hold that the award was proper.

VII

Liberty argues that the district court abused its discretion in denying Liberty's motion for a new trial based on the punitive damage award.

A

First, Liberty argues that the district court abused its discretion in not granting Liberty's motion for a new trial. Liberty maintains that its refusal to defend was reasonable and does not support an award of punitive damages.

"Under California law, punitive damages are not available for breaches of contract no matter how gross or willful. Punitive damages are recoverable, however, when the defendant breaches the implied covenant of good faith and fair dealing *and* is guilty of oppression, fraud or malice." *Tibbs*, 755 F.2d at 1370 (citation omitted) (emphasis in original); *see also Neal v. Farmers Ins. Exch.*, 582 P.2d 980, 986 (Cal. 1978) (insurer must have "acted maliciously, with an intent to oppress, and in conscious disregard of the rights of the insured"). "Put another way, punitive damages are recoverable only where the defendant acted with the intent to vex, injure, or annoy." *Slottow v. American Cas. Co.*, 10 F.3d 1355, 1361 (9th Cir. 1993) (quotation omitted).

The district court did not abuse its discretion in refusing Liberty's motion for a new trial. "[T]he requisite state of mind . . . may be proved either expressly . . . or by implication (by indirect evidence from which the jury may draw inferences)." *Neal*, 582 P.2d at 987 (quotation omitted). From evidence presented at trial, the jury could

have inferred that Liberty fraudulently misrepresented the facts regarding Chemstar's coverage and consciously disregarded Chemstar's rights under the policy. *See Tibbs*, 755 F.2d at 1375.

B

Liberty also argues that the district court should have ordered a new trial because the $14 million punitive damage award was excessive. Under California law, an award should be reversed "only when the award as a matter of law appears excessive, or where the recovery is so grossly disproportionate as to raise a presumption that it is the result of passion or prejudice." *Neal*, 582 P.2d at 990.

The district court did not abuse its discretion in deciding that the award was not excessive; it was comparable to other awards upheld under California law. First, the $14 million punitive damage award was five times the $2.8 million compensatory damage award. California courts have upheld much larger ratios. *See, e.g., id.* (32.7:1 ratio); *Moore v. American United Life Ins. Co.*, 197 Cal. Rptr. 878, 894 (Cal. App. 1984) (83:1 ratio); *Chodos v. Insurance Co. of N. Am.*, 178 Cal. Rptr. 831, 841 (Cal. App. 1982) (40:1 ratio); *Finney v. Lockhart*, 217 P.2d 19 (Cal. 1950) (2000:1 ratio).

Second, the award was about two-thirds of one percent of Liberty's $2.1 billion net worth. California courts have upheld punitive damage awards that were larger percentages of insurers' net worth. *See, e.g., Downey Sav. & Loan Ass'n v. Ohio Cas. Ins.*, 234 Cal. Rptr. 835, 851 (Cal. App. 1987)

(about 2% of net worth), *cert. denied*, 486 U.S. 1036 (1988); *Moore*, 197 Cal. Rptr. at 898 (3.2% of net worth).

AFFIRMED.

Chemstar, Inc. v. Liberty Mutual Insurance Co.,
No. 92-55472
(Filed Nov. 16, 1994)

Fernandez, J., concurring:

I concur in everything in the disposition, with the exception of the determination in Part II that *State Farm Mutual Automobile Insurance Co. v. Longden*, 242 Cal. Rptr. 726, 731 (Cal. App. 1987) is an incorrect statement of California law. In my opinion, that court properly held that the existence of the disputed legal question does not impose a duty to defend upon the insurer. *See also McLaughlin v. National Union Fire Ins. Co.*, 23 Cal. App. 4th 1132, 1151-52, 29 Cal. Rptr. 2d 559, 570 (1994). Indeed, it is somewhat counter-intuitive to say that an insurer which correctly understood the law of the State of California is nevertheless liable because somebody chose to make a contrary argument. That, of course, is not at all similar to disputes over legal theories set forth in complaints or disputes over factual matters. Having said all of this, I still concur because, as we have demonstrated in our opinion regarding Phase II, Liberty's legal analysis was wrong. In other words, it did breach its duty to defend.

NOT FOR PUBLICATION

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

CHEMSTAR, INC., Plaintiff-Appellee, v. LIBERTY MUTUAL INSURANCE COMPANY, Defendant-Appellant, and GENSTAR CORPORATION; NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA.; INDUSTRIAL INSURANCE COMPANY OF HAWAII, LTD.; AMERICAN HOME ASSURANCE COMPANY; EMPLOYERS INSURANCE OF WAUSAU, UNITED INSURANCE, Defendants.	No. 93-55555 D.C. No. CV-90-02904-HLH (Filed Nov. 16, 1994)
CHEMSTAR, INC., Plaintiff-Appellant, v. LIBERTY MUTUAL INSURANCE CO.; GENSTAR CORPORATION; NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA.; INDUSTRIAL	No. 93-55557 D.C. No. CV-90-02904-HLH

INSURANCE COMPANY OF HAWAII, LTD.; AMERICAN HOME ASSURANCE COMPANY; EMPLOYERS INSURANCE OF WAUSAU; UNITED INSURANCE,

Defendants-Appellees.

CHEMSTAR, INC.,

Plaintiff-Appellee,

v.

LIBERTY MUTUAL INSURANCE CO.; GENSTAR CORPORATION; NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH PA.; INDUSTRIAL INSURANCE COMPANY OF HAWAII, LTD.; AMERICAN HOME ASSURANCE COMPANY; EMPLOYERS INSURANCE OF WAUSAU,

Defendants,

and

UNITED INSURANCE,

Defendant-Appellant.

No. 93-55558

D.C. No. CV-90-02904-HLH

CHEMSTAR, INC.,

Plaintiff-Appellee,

v.

LIBERTY MUTUAL INSURANCE CO.; GENSTAR CORPORATION; NATIONAL

No. 93-55560

D.C. No. CV-90-02904-HLH

UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA.; INDUSTRIAL INSURANCE COMPANY OF HAWAII, LTD.; AMERICAN HOME ASSURANCE COMPANY; UNITED INSURANCE,

Defendants,

and

EMPLOYERS INSURANCE OF WAUSAU,

Defendant-Appellant.

CHEMSTAR, INC.,

Plaintiff-Appellee,

v.

LIBERTY MUTUAL INSURANCE CO.; GENSTAR CORPORATION; NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA.; INDUSTRIAL INSURANCE COMPANY OF HAWAII, LTD.; EMPLOYERS INSURANCE OF WAUSAU; UNITED INSURANCE,

Defendants,

and

AMERICAN HOME ASSURANCE COMPANY,

Defendant-Appellant.

No. 93-55561

D.C. No. CV-90-02904-HLH

MEMORANDUM*

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*This disposition is not appropriate for publication and may not be cited to or by the courts of this circuit except as provided by Ninth Circuit Rule 36-3.

Appeal from the United States District Court for the Central District of California

Harry L. Hupp, District Judge, Presiding

Argued and Submitted March 7, 1994
Pasadena, California

Before: **O'SCANNLAIN, FERNANDEZ,** and **T.G. NELSON,** Circuit Judges.

This memorandum disposition addresses certain Phase II issues not discussed in the separate opinion filed concurrently herewith. An additional memorandum disposition, filed concurrently herewith, deals with the Phase I issues.

I

In its Phase I Judgment on Special Jury Verdict, the district court awarded Chemstar, Inc. ("Chemstar") compensatory damages for amounts paid to settle the Friedman claim and to defend plaster pitting claims after Liberty had withdrawn its defense. Later, in an October 26, 1992 order, the district court found that Liberty Mutual Insurance Company ("Liberty") had exhausted its $2 million coverage limit on April 17, 1991. Liberty asserts that the district court improperly ordered it to pay for the Friedman settlement and Chemstar's defense costs, sums exceeding Liberty's coverage limits.

Liberty's argument fails. Liberty entered into a stipulation in October 1992 in which it agreed that the district court's October 26, 1992 finding would not be binding on Chemstar. Liberty argues that this stipulation barred it from asserting exhaustion *only* on the basis of the district

court's October 26, 1992 disposition of its summary judgment motion. According to Liberty, the stipulation does not prevent it from asserting exhaustion based upon the district court's March 10, 1993 declaratory judgment.

We disagree. The March 10, 1993 judgment did not make an independent finding as to the date that Liberty exhausted its coverage but, instead, simply incorporated the finding of the October 26, 1992 order. Under the circumstances, and given the fact that Chemstar surrendered potentially valuable claims against Liberty in exchange for the stipulation, we find Liberty's proferred reading of the stipulation to be untenable.

II

On December 21, 1992, the district court granted partial summary judgment in favor of Liberty against American Home Assurance Company's ("American") second amended counterclaim and cross-claim, finding that American could not assert waiver and estoppel claims based on Liberty's breach of its duty to defend Chemstar. The district court later required American to pay for all of Chemstar's covered defense and settlement costs exceeding Liberty's $2 million coverage limits. American challenges these decisions.

American asserts that Liberty has lost its right to assert exhaustion as a defense to coverage because it abandoned Chemstar's defense in bad faith after first defending without a reservation of rights. We disagree. The mere fact that Liberty defended Chemstar without a reservation of rights did not cause Liberty to waive, or to become estopped from asserting, its policy limits as a

defense to coverage. "While the defense of [an] action by the insurer may constitute a waiver of defenses by it, it does not rewrite the policy so as to remove the maximum of the coverage provided." 14 *Couch on Insurance 2d* § 51:93, at 595 (1982). Liberty's bad faith breach of its duty to defend Chemstar does not avail American. Liberty has compensated Chemstar for all losses that its actions caused Chemstar, and American must pay only those settlement and defense costs in excess of Liberty's policy limits. Further, despite ample opportunity afforded by the district court, American never has demonstrated how it has been directly injured by Liberty's conduct. Under these conditions, we agree with the district court's finding that Chemstar had no claim against Liberty to assign to American or to which American could become subrogated. *See Intel Corp. v. Hartford Accident & Indem. Co.*, 952 F.2d 1551, 1561 (9th Cir. 1991) (no waiver where no prejudice); *Valentine v. Aetna Ins. Co.*, 564 F.2d 292, 297 (9th Cir. 1978) ("[W]hen a loss cannot be causally related to some alleged breach of duty on the part of the defendant, then neither a plaintiff, nor his insurer through equitable subrogation, can have a cause of action against the defendant.").

Finally, American argues that Liberty breached its duty of good faith and fair dealing to American because it waited until after the district court's July 23, 1992 summary judgment to assert that plaster pitting losses should be allocated to one, rather than three, policy periods. The district court properly characterized this argument as "frivolous." Liberty properly reallocated the plaster pitting losses from three policy years to one policy year as a result of the district court's rulings.

III

In its July 23, 1992 summary judgment, the district court held that National Union Fire Insurance Company of Pittsburgh, Pennsylvania ("National") was not required to share Chemstar's defense costs with Liberty because National's policy did not cover any of the plaster pitting damage. Liberty challenges this decision, arguing that, because National was potentially liable for coverage at the outset of this litigation, it had a duty to defend Chemstar.

The district court's apportionment of defense costs was correct. "The costs of defense must be apportioned on the basis of equitable considerations not found in the insurers own contracts, since the insurance companies who must share the burden do not have any agreements among themselves." *CNA Casualty of California v. Seaboard Sur. Co.*, 222 Cal. Rptr. 276, 288 (Cal. App. 1986). "It is an accepted principle of California law that where two insurers cover the same risk, defense costs must also be shared between them pro rata in proportion to the respective coverage afforded by them to the insured." *Id.* at 289 (internal quotation omitted). Since National's policy afforded no coverage of Chemstar's losses, its pro rata share of Chemstar's defense costs was zero.

IV

Liberty states that the district court improperly required it to pay a 10% post-judgment interest rate, rather than a 4.21% rate, in its February 10, 1992 Judgment on Special Jury Verdict (Phase I).

Liberty has raised this issue too late. First, because the district court awarded post-judgment interest as part of its Phase I judgment, Liberty should have argued this issue in its Phase I appeal. Instead, it raises the issue for the first time in its Phase II appeal. Second, Liberty failed to raise this issue with the district court. Because the appropriate interest rate is a question of fact not answerable from the record, we decline to consider the question for the first time on appeal. *See In re Professional Inv. Properties of Am.*, 955 F.2d 623, 625 (9th Cir.), *cert. denied*, 113 S. Ct. 63 (1992).

AFFIRMED.

United States District Court
Central District of California
Los Angeles, California

CHEMSTAR INC. Plaintiff	*	Docket No. CV-90-2904-HLH
vs.	*	Los Angeles, California
LIBERTY MUTUAL, ET AL. Defendant	*	July 22, 1991 3:30 p.m.

STATUS CONFERENCE TO SET DATES

THE HONORABLE HARRY L. HUPP PRESIDING
UNITED STATES DISTRICT COURT JUDGE

COURT RECORDER:	TRANSCRIPTION BY:
LIBBIE KOBZEFF U.S. District Court	NORTHWEST TRANSCRIPTS, INC. California Division P.O. Box 2390 Monrovia, California 91017 (818) 574-1075

Proceedings recorded by electronic sound recording, transcript produced by transcription service.

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FOR DEFENDANT WAUSAU:	PAUL R. FINE, Attorney Daniels, Baratta & Fine 1801 Century Park East, Ninth Floor Los Angeles, California 90067

FOR DEFENDANT NATIONAL UNION:	BRADFORD H. MILLER, Attorney Murtaugh, Miller, Meyer & Nelson 1120 West La Veta Avenue, Suite 700 Orange, California 92668-4220
FOR DEFENDANT INDUSTRIAL INSURANCE CO. OF HAWAII, LTD.:	ROGER E. MARKEN, Attorney Ives, Kirwan & Dibble 520 South Grand Avenue, Fourth Floor Los Angeles, California 90071

[p. 3] PROCEEDINGS BEGIN AT 3:30 P.M.

(Court is Called to Order)

THE COURT: All right, Chemstar against Liberty Mutual and the rest of the world. I'm sorry, counsel. Might as well have you march up and state your appearances if you haven't already checked in at least with Ms. Borgarding. We'll start with Mr. Beaver who's at the head of the line here.

MR. BEAVER: Your Honor, Dave Beaver with Dinsmore & Shohl in Cincinnati on behalf of Liberty Mutual.

MR. LONG: Good afternoon, Your Honor. Thomas Long with Nossaman, Guthner, Knox & Elliott on behalf of the named insured, Genstar Corporation.

MR. FINE: Paul Fine on behalf of Wausau.

THE COURT: Let me catch your name again?

MR. FINE: Paul Fine.

THE COURT: Oh yes. Right.

MR. MILLER: Good afternoon, Your honor. Brad Miller for National Union.

THE COURT: Right.

MS. COHEN: Good afternoon. Gail Cohen with Barger & Wolen for United Insurance Company.

THE COURT: That's United?

MS. COHEN: United, yes Your Honor.

THE COURT: Okay. . . .

* * *

[p. 76] THE COURT: All right, now here's what I'm going to do. I'm going to bifurcate out the duty to defend issues as between Liberty and Chemstar. Would you make notes on this Andrea? Just a minute here.

(Pause)

And I'm going to set a – to the extent that any motion for summary judgement doesn't dispose of these issues, I'm going to set a pretrial conference on the first Friday of October, which means a November trial on those issues. What's the first Friday of October?

THE CLERK: The fourth.

THE COURT: October 4, 1991 at 1:30 with a trial in November 1991 at an exact date to be set after pretrial conference and with a discovery cutoff. Can you gentlemen live with a September 1 discovery cutoff?

MR. OSTER: Yes, Your Honor.

MR. LONG: Your Honor, is that applying to all –

[p. 77] THE COURT: No, just the bifurcated issues. This is just between Chemstar and Liberty Mutual. The rest – the rest of the parties are not effected [sic] by this.

MR. BEAVER: With a September 1 cutoff with regard to other than experts?

THE COURT: No. I had contemplated that for – for all. If you – if you want to work it out to do your experts during September, that's okay with me.

MR. BEAVER: Well, I don't trust –

THE COURT: I don't want to squawk about it. Normally we have all the discovery cutoff about one month ahead of the pretrial conference around here. And the pretrial conference about one month before trial –

MR. BEAVER: I'm concerned about –

THE COURT: – in round numbers.

MR. BEAVER: I'm concerned about the experts having time and the experts getting – their depositions being taken. I mean, surely Liberty objects to the bifurcation but if – but if we're working on that pretrial date, then the discovery cutoff you mentioned seems as reasonable as you can get in the situation for the general discovery, Your Honor. But we'd like an additional two weeks for the experts.

THE COURT: All right. Is that okay with you, Mr. Oster? . . .

* * *

[p. 79] THE COURT: All right. Except experts to be – expert discovery to be September 20? Can you do that?

MR. OSTER: Yes.

THE COURT: All right. Have that in there. Then I will not – in the bifurcated trial there are not to be any issues which effect [sic] coverage issues of other carriers.

MR. LONG: Your Honor, you don't mean just to limit that to other carriers do you?

THE COURT: Other parties.

MR. LONG: Okay.

THE COURT: I might have to – if we get some retrospective issues that I – I just don't know about that pop up, I'm not going to – I've got to go ahead with this duty to defend case.

MR. LONG: Well, Your Honor are you saying you would anticipate adjudicating retrospective premium issues?

[p. 80] THE COURT: Absolutely not.

MR. LONG: Okay. I mean, it would be my understanding that Your Honor's bifurcation order, which we would have no particular objection to, would address only duty to defend in a way that would not effect [sic] any coverage issues or any retrospective premium issues. And if I'm understanding that –

THE COURT: Well, okay. Except that I don't know what effects [sic] retrospective premium issues. If they're

going to – if Liberty gets stuck paying Chemstar's lawyers fees for defending these things and they want to charge it back to you under a retrospective premium issue, I'm not going to hold up deciding that.

MR. LONG: Okay, I guess – I guess that then gets back to the concern we had that if somehow Liberty's going to be saddled with the responsibility under a theory that somehow expands what its obligations normally would have been, we would contend Liberty's out of luck. Liberty would clearly contend it's not. And if that issue is reserved, it may be that the bifurcation doesn't prejudice but it may be the bifurcation you're describing does prejudice.

THE COURT: All right.

MR. LONG: So I guess I don't understand it.

THE COURT: If it – if it does, it's got to indirect.

[p. 81] MR. LONG: Okay. Well I would just preserve our objection to it then based on what I said.

THE COURT: Okay, your objection is preserved. Only that's the way I'm going to do it.

* * *

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

CIVIL MINUTES – GENERAL

No. CV 90-2904-HLH Date July 22, 1991

Title Chemstar, Inc. v. Liberty Mutual Insurance Co., et al.

DOCKET ENTRY

PRESENT:
HON. HARRY L. HUPP,
JUDGE

Milli Borgarding	Libby Kobzeff
Deputy Clerk	Court Reporter

ATTORNEYS PRESENT FOR PLAINTIFFS:	ATTORNEYS PRESENT FOR DEFENDANTS:
Ronald M. Oster	David H. Beaver
Michael E. Kohn	Thomas D. Long
	Paul R. Fine
	Bradford H. Miller
	Gail E. Cohen
	Douglas Lacky
	Roger E. Marken

PROCEEDINGS: STATUS CONFERENCE

AUG 05 1991
RECEIVED

ORDER (also, if applicable, findings and memorandum opinion):

Case called. Court and counsel conferred.

The Court orders the bifurcation of the duty to defend issues as between Liberty Mutual Insurance Co.

and Chemstar, Inc. The Court sets the following dates for the duty to defend issues to be resolved (to the extent that they are not resolved by motion for summary judgment):

September 1, 1991	–	Discovery Cut-off
September 15, 1991	–	Discovery Cut off for Experts
October 4, 1991	–	Pretrial Conference (1:30 p.m.)
November of 1991	–	Trial (exact date to be set at Pretrial Conference)

The bifurcation of the duty to defend issues will not effect [sic] any coverage issues which these or other parties may have.

A status conference to set dates for the remaining portions of this action is scheduled for November 18, 1991, at 8:30 a.m.

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

CIVIL MINUTES – GENERAL

Case No. CV 90-2904-HLH Date Aug. 2, 1991

Title Chemstar, Inc. v. Liberty Mutual Insurance Co., et al.

DOCKET ENTRY

PRESENT:
HON. HARRY L. HUPP,
JUDGE
Milli Borgarding
Deputy Clerk

Court Reporter

ATTORNEYS PRESENT FOR PLAINTIFFS:
Ronald M. Oster
Michael E. Kohn

ATTORNEYS PRESENT FOR DEFENDANTS:
David H. Beaver
R. Skocypoec

PROCEEDINGS: CHEMSTAR'S MOTION FOR SUMMARY JUDGMENT AGAINST LIBERTY MUTUAL ON LIABILITY ISSUES

ORDER (also, if applicable, findings and memorandum opinion):

Plaintiff's motion for summary judgment is granted in part as follows: Issues A and B as listed in the notice of motion (pg. 3, l. 24 to pg. 4, l. 2) are established for purposes of this action. The motion is denied as to Issue C (pg. 4, l. 4-8).

There is no dispute in the evidence submitted to the court that Chemstar is the same corporate entity as Genstar Lime Co. (GLC), a named insured under the policy of insurance issued by Liberty Mutual Insurance Co. (Liberty). While Liberty's points and authorities argue otherwise without supporting declaration, there is no refutation of the showing that: 1. GLC was a wholly owned subsidiary of Flintkote, itself a wholly owned subsidiary of Genstar. 2. Liberty issued its policies to Genstar, and included as named insureds Flintkote and GLC. 3. Flintkote sold all of the stock in GLC to Chemstar (formerly known as Newco before a change of name). The contract of sale provided that GLC kept its insurance contracts on the sale. 4. GLC was then merged into its new parent corporation, Chemstar, with the effect that Chemstar is the same corporate entity as GLC. 5. If relevant, the lime which was the source of the plaster pitting claims was manufactured by GLC before the sale of its stock to Chemstar and the plaster with the bad lime was installed in the homes before the sale of GLC's stock to Chemstar. Some plaster pitting claims were made before and some after the sale. 6. Liberty assumed without a reservation of rights the defense of all claims whether against GLC, Chemstar, Genstar, and Flintkote until 1989, when it stopped defending Chemstar on the supposed ground that Chemstar was not its insured. 7. Liberty on the day after the sale of GLC stock to Chemstar gave Genstar (or its parent, IMASCO) an endorsement purporting to delete GLC as a named insured, but there is no evidence that it gave GLC a notice of cancellation.

On these undisputed facts, Chemstar is entitled to the same rights and benefits as GLC under the Liberty

policy, and it is so adjudicated. The parties talk about Chemstar being the successor in interest to GLC and in a lay sense it is. More importantly, Chemstar is the same corporate entity as GLC, having been merged into Chemstar.

Liberty objects that the policy could not be assigned without its consent. Assuming that this is relevant (Chemstar being the same corporate entity as the named insured), with all of the events bringing liability occurring before the "assignment", the policy may be assigned without consent. (*International Rediscount Corp.* DDel'77 425 FSupp 669.)

Liberty raises an issue as to coverage, although it did not mention the issue when it abruptly ceased its defense of Chemstar in November 1989. It now says that certain of the plaster pitting claims (about 10 of 28) were not asserted until after the sale of the GLC stock to Chemstar, and that presumably the damage in many of those cases did not manifest itself until after the sale and deletion of GLC from the Liberty policy. Defining occurrence as when [the] damage occurred, Liberty says that the occurrence was not within its coverage for at least some of the claims. Thus, Liberty says that there was no duty to defend that portion of the 28 claims. The court rejects this argument for multiple reasons. In the first place, this argument was not even hinted at while Liberty was providing a defense or when it stopped doing so on the ostensible ground that Chemstar was not an insured. Liberty, at an earlier stage of this case, was asserting (presumably for the purpose of arguing that since there was only one occurrence, the $2,000,000 per occurrence limit applied) that the manufacture of the batch of bad

lime was the occurrence, which happened once, thus limiting its coverage to the limit per occurrence. An insurer may not blow hot and cold in this way and leave its insured without defense. In addition, it is not clear when the damage took place; the time of making the claim does not necessarily establish the date of damage. Thus, from several aspects, the question of coverage is not clearly and sharply defined. That being the case, a defense (albeit one that could have been accompanied by a reservation of rights) was owed as to all of the plaster pitting claims, not just the 17 or 18 where coverage was clear and indisputable.

It is concluded that Liberty had the duty to defend Chemstar on all claims. Liberty breached that duty by abandoning the defense in 1989. In this motion, duty to indemnify is not at issue; duty to defend is. Since there is a potential for liability to indemnify on the part of Liberty to GLC and its successor Chemstar, Liberty had the duty to defend even if it might not ultimately have to indemnify. It is not necessary to determine whether the act of Liberty in defending for 2 years without a reservation in addition requires it to continue the defense.

Item C of the motion (to determine that the failure to defend was a breach of the duty of good faith and fair dealing owed by an insurer to its insured) cannot be adjudicated on summary judgment, involving, as it does, a consideration of intent and motivation matters.

UNITED STATES DISTRICT COURT

CENTRAL DISTRICT OF CALIFORNIA

BEFORE: THE HONORABLE HARRY L. HUPP, JUDGE RESIDING

CHEMSTAR, INC., AN ARIZONA CORPORATION, PLAINTIFF, V LIBERTY MUTUAL INSURANCE COMPANY, A MASSACHUSETTS CORPORATION, ET AL., DEFENDANTS.	CASE NO. CV 90-2904-HLH

REPORTER'S TRANSCRIPT OF PROCEEDINGS

LOS ANGELES, CALIFORNIA

THURSDAY, NOVEMBER 21, 1991

APPEARANCES

FOR THE PLAINTIFF: PAUL, HASTINGS, JANOFSKY & WALKER
BY: Ronald M. Oster &
Robert L. Meylan
Attorneys at Law
555 South Flower Street
Los Angeles, California
90017

FOR THE DEFENDANT: DINSMORE & SHOHL
BY: David H. Beaver
Brian Sullivan &
Robert Furnier
Attorneys at Law
255 East Fifth Street
Cincinnati, Ohio 45202

GRACE, SKOCYPEC,
COSGROVE & SCHIRM
BY: RONALD J.
SKOCYPEC
Attorney at Law
5700 Wilshire Boulevard
Suite 300N
Los Angeles, California
90036

[p. 10] * * *

THE COURT: All right. Motion number three is the first of Chemstar's motion in limine to exclude evidence regarding the question of whether other insurers' policies may cover the plaster pitting claims, and that other insurers entered into a settlement or partial settlement with Chemstar. That motion looks good to me.

Mr. Sullivan, do you want to comment on that?

MR. SULLIVAN: Yes, I would, Your Honor. Chemstar's argument in its memorandum of contentions of law and fact in this case is that part of its damage stems from its inability to tender claims to its other carriers because of Liberty's conduct. That is a point at which they have used to show damage; in other words, it is our contention that if they can use the evidence [p. 11]

of other carriers which are out there which they cannot turn to, that Liberty can also use that evidence.

THE COURT: What evidence are you going to present about that, Mr. Oster?

MR. OSTER: Absolutely nothing, Your Honor. We want to make a motion in limine and then introduce evidence on the same –

THE COURT: That motion is granted. The Chemstar motion to exclude evidence regarding other insurers, I've numbered that number three.

* * *

CENTRAL DISTRICT OF CALIFORNIA

CIVIL MINUTES - GENERAL

No. CV90-2904-HLH(Bx) Date 12/23/91

Chemstar, Inc. v. Liberty Mutual Ins. Co. et al

DOCKET ENTRY

THE DOCUMENT WAS SERVED BY FIRST-CLASS MAIL ON ALL COUNSEL (OR PARTIES AT THEIR MOST RECENT ADDRESS OF RECORD) IN THIS ACTION ON THIS DATE:

DATED: DEC 23, 1991

By: _____
DEPUTY CLERK (signing attst mailing)

PRESENT:

HON. HARRY L. HUPP, JUDGE

/s/ Karen Kirksey	N/A
Deputy Clerk	Court Reporter
ATTORNEYS PRESENT FOR PLAINTIFFS:	ATTORNEYS PRESENT FOR DEFENDANTS:
None Present	None Present

PROCEEDINGS: EX PARTE MOTION BY LIBERTY MUTUAL

ORDER (also, if applicable, findings and memorandum opinion):

The ex-parte motion by Liberty Mutual to reconsider the order on the motion for summary judgment is denied.

The principal problem with the motion to reconsider is something which Liberty Mutual has never acknowledged – that since the date of occurrence may well be held to be the date the first homeowner suffered damage, all of the claims must be defended. Thus, whether or not the Friedman damage was first noted by Friedman before or after the date of the sale of Genstar Lime stock (and cancellation of Genstar Lime's insurance), Liberty Mutual owes Genstar Lime (aka Chemstar) a defense to all of the claims. It follows that it does not matter whether as to Friedman Liberty Mutual noted date of loss as another reason to deny a defense.

Chemstar need not reply to the motion.

B:902904.1223

Initials of Deputy Clerk KJK

RONALD M. OSTER
MICHAEL E. KOHN
ROBERT L. MEYLAN
PAUL, HASTINGS, JANOFSKY & WALKER
Twenty-Third Floor
555 South Flower Street
Los Angeles, California 90071
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Attorneys for Plaintiff
CHEMSTAR, INC.

UNITED STATES DISTRICT COURT

FOR THE CENTRAL DISTRICT OF CALIFORNIA

CHEMSTAR, INC., an Arizona corporation, Plaintiff, vs. LIBERTY MUTUAL INSURANCE COMPANY, a Massachusetts corporation, et al., Defendants. AND RELATED CLAIMS.	CASE NO. 90 2904 HLH (Bx) JUDGMENT ON SPECIAL JURY VERDICT Phase I Trial Date: November 19, 1991 Time: 8:30 a.m. Ctrm: 7 (Filed Feb. 10, 1992) (Entered Feb. 13, 1992)

This case came on regularly for trial on November 19, 1991 in the Courtroom of the Honorable Harry L. Hupp, United States District Judge presiding. Plaintiff appeared by counsel Ronald M. Oster and Robert L. Meylan from the law firm of Paul, Hastings, Janofsky & Walker. Defendant appeared by counsel, David Beaver, Robert Furnier and Brian Sullivan from the law firm of Dinsmore &

Shohl and Ronald Skocypec from the law firm of Grace, Skocypec, Cosgrove & Schirm.

A jury of eight persons was regularly impaneled and sworn to try the action. Witnesses on the part of both plaintiff and defendant were duly and properly sworn and examined in person or by deposition testimony. After hearing the evidence and arguments of counsel, the Court instructed the jury and the special verdict issues were submitted to the jury for answers to such issues. After the selection of two alternate jurors, the six members of the jury deliberated and thereafter returned into Court with their verdict consisting of special issues submitted to the jury and the answers given thereto by the jury, and being called, answered to their names and duly rendered their verdict in writing, words and figures as follows:

"TITLE OF COURT AND CAUSE"

We, the jury in the above-entitled case, find the following special verdict on the questions submitted to us:

QUESTION NO. 1: What is the total amount of money, including attorneys' fees, Chemstar was reasonably required to spend in order to defend itself in the plaster claims?

Answer: $ 838,398.00

QUESTION NO. 2: How much of that money was for services rendered prior to April 17, 1991?

Answer: $ 704,615.00

QUESTION NO. 3: What is the total amount of money Chemstar was reasonably required to spend in order to settle the *Friedman* claim?

Answer: $ 750,957.00

QUESTION NO. 4: Did Liberty Mutual Insurance Company breach its duty of good faith and fair dealing toward Chemstar when Liberty Mutual Insurance Company stopped defending Chemstar in the plaster claims?

Answer "yes" or "no."

Answer: Yes

If you answer Question No. 4 "yes," then answer all remaining questions.

If you answer Question No. 4 "no," then skip Question Nos. 5 and 6 and answer Question Nos. 7 and 8.

QUESTION NO. 5: What is the total amount of money, including attorneys' fees, Chemstar was reasonably required to spend in this action in order to recover the amount spent to defend itself in the plaster claims and to settle the *Friedman* claim?

Answer: $ $1,201,611.00

QUESTION NO. 6: Did Liberty Mutual Insurance Company act with oppression, fraud or malice toward Chemstar in the plaster claims?

Answer "yes" or "no."

Answer: Yes

QUESTION NO. 7: Did the jury, in its discretion, determine that punitive damages should be awarded to Chemstar?

Answer "yes" or "no."

Answer: Yes

DATED: January 9, 1992

/s/ Robert Sperling
Foreperson

The jury found "oppession, fraud or malice" in the conduct of Liberty Mutual Insurance Company and determined that in their discretion, punitive damages should be awarded. Based on that finding, the jury heard additional evidence, arguments of counsel and instructions from the Court. The six jurors retired to consider their verdict and subsequently returned into Court, and being called, answered to their names and duly rendered their verdict in writing, words and figures as follows:

"TITLE OF COURT AND CAUSE"

We, the jury in the above-entitled case, find punitive damages in favor of plaintiff Chemstar, Inc. and against defendant Liberty Mutual Insurance Company in the amount of $ 14,000,000.00

DATED: January 9, 1992

/s/ Robert Sperling
Foreperson

NOW, BY REASON OF SAID SPECIAL VERDICT, IT IS ORDERED, ADJUDGED AND DECREED:

That plaintiff Chamstar, Inc. have judgment for actual and compensatory damages against defendant Liberty Mutual Insurance Company for the sum of $2,790,966.00, with interest thereon at the legal rate per annum, accruing daily in the amount of $764.65;

That plaintiff Chemstar, Inc. have judgment for pre-judgment interest at the rate of seven percent on actual and compensatory damages of $1,589,355.00 awarded pursuant to special verdict issue nos. 1 and 3 from the time each portion of said sum was incurred by plaintiff Chemstar, Inc. to January 9, 1992, the total amount of such interest being $133,134.46;

That plaintiff Chemstar, Inc. have judgment for punitive damages against defendant Liberty Mutual Insurance Company for the sum of $14,000,000, with interest thereon at the legal rate per annum, accruing daily in the amount of $3,835.62;

AND

Further, there being no just reason for delay and pursuant to Federal Rule of Civil Procedure 54(b), the Court directs that the foregoing be entered as a final judgment.

DATED: February 13, 1992

Submitted By:

RONALD M. OSTER
MICHAEL E. KOHN
ROBERT L. MEYLAN
PAUL, HASTINGS, JANOFSKY & WALKER

By: /s/ Michael E. Kohn
Michael E. Kohn
Attorneys for Plaintiff
CHEMSTAR, INC.

DATED: 2-10 , 1992

HARRY L. HUPP
UNITED STATES DISTRICT
COURT JUDGE

PROOF OF SERVICE

STATE OF CALIFORNIA)
) ss:
CITY AND COUNTY OF LOS ANGELES)

I am employed in the City and County of Los Angeles, California. I am over the age of 18 and not a party to the within action. My business address is 555 South Flower Street, Twenty-Third Floor, Los Angeles, California 90071-2371.

On February 3, 1992, I served the foregoing document(s) described as:

JUDGMENT ON SPECIAL JURY VERDICT

on the interested parties by placing a true copy thereof in a sealed envelope(s) as stated on the attached mailing list:

SEE ATTACHED SERVICE LIST.

I caused such envelope(s) with postage thereon fully prepaid to be placed in the United States mail at a facility maintained by the United States Postal Service at Los Angeles, California.

I declare that I am employed in the office of a member of the bar of this Court at whose direction the service was made.

Executed on February 3, 1992 at Los Angeles, California.

Marie Clarey	/s/ Marie Clarey
Type of Print Name	Signature

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

CIVIL MINUTES – GENERAL

Case No. CV 90-2904-HLH Date March 16, 1992

Title Chemstar, Inc. v. Liberty Mutual Insurance Co., et al.

DOCKET ENTRY

TENTATIVE RULING

PRESENT: HON. HARRY L. HUPP, JUDGE

Milli Borgarding Deputy Clerk	Court Reporter
ATTORNEYS PRESENT FOR PLAINTIFFS:	**ATTORNEYS PRESENT FOR DEFENDANTS:**
Ronald Oster	David Beaver
ATTORNEYS PRESENT FOR GENSTAR CORPORATION: Thomas Long	ATTORNEYS FOR AMERICAN HOME ASSURANCE COMPANY: Brian Zimmerman

PROCEEDINGS: DEFENDANT'S MOTION FOR JUDGMENT AS A MATTER OF LAW, NEW TRIAL OR REMITTITUR AS TO PHASE I TRIAL

GENSTAR CORPORATION'S MOTION FOR LEAVE TO FILE THIRD AMENDED COUNTERCLAIM AND CROSS-CLAIM

ORDER (also if applicable, findings and memorandum opinion):

AMERICAN HOME ASSURANCE COMPANY'S MOTION FOR PARTIAL SUMMARY JUDGMENT RE: WAIVER AND ESTOPPEL (JOINED BY PLAINTIFF CHEMSTAR)

1. The motion for judgment NOV, for new trial, or for remittitur, is denied.

There have been times during the progress of this case up to this point when the court has wondered if Liberty Mutual ("Liberty") is looking at the same evidence the court and jury heard. Specifically, Liberty still asserts that Chemstar was not its insured, or at least that it took reasonable steps to determine whether it was. The evidence, however, is uncontradicted that Chemstar was at all times Liberty's insured until the policy was cancelled in Dec., 1986, and that Liberty therefore kept the obligation to defend claims potentially within policy coverage prior to that time.

To recapitulate once again: Liberty insured Genstar and its subsidiaries. Flintkote was a subsidiary of Genstar and Genstar Lime Co. was a corporate subsidiary of Flintkote. All of the Genstar corporations were insureds under the Liberty policies and Liberty owed a duty to defend all of them. Flintkote sold the capital stock of Genstar Lime Co. to Newco, who changed its name to Chemstar, and merged with Genstar Lime Co. The corporate assets of Genstar Lime Co., including its contract rights to be defended by Liberty, thus became an asset of Chemstar. Liberty cancelled coverage for Genstar Lime Co. as of the date of the stock sale, but, of course, still owed the obligations to defend claims of damage resulted from occurrences taking place before the sale. The 28 plaster pitting claims resulting from a batch of bad lime

manufactured by Genstar Lime Co. before the sale and installed, as a component of plaster, in the 28 homes before the sale. The plaster pitted. The pitting was noticed in some of the homes (about 17) before Dec., 1986, and in the others (about 11) afterwards. There is a coverage question extant (still undecided since no motion has been made to determine it) as to whether Liberty's policy provides coverage for all 28 claims or only for 17. This may, depending on policy interpretation, depend on whether there is one or 28 occurrences and, further, may depend on when damage was first noticed. However, there is a potential for coverage on all of the claims and, thus, under California law, Liberty owed Chemstar the duty to defend them all. After defending the claims for three years without a reservation of rights, Liberty, without notice to Chemstar, abandoned the defense of the claims, taking the position that Chemstar is not an insured. The conclusion that Chemstar was not an insured is inexplicable, even astounding, since Chemstar is the same corporate entity as Genstar Lime Co., which Liberty admits is an insured.

Liberty argues that there is insufficient evidence to support the finding by the jury of bad faith breach of the duty to defend. This finding was permissible on evidence that Liberty took the action (failing to defend) "unreasonably and without proper cause". The facts were that Liberty knew from the beginning, and confirmed when coverage was at issue, that the 1986 transaction involved a sale of stock of Genstar Lime Co. Thus, the Liberty executives making the decision knew that the corporate entity of Genstar Lime Co. continued on with its assets intact, including its rights under the Liberty policy. These

same executives made no inquiry of anyone (Genstar or Chemstar, with whom it had been dealing regularly in its 3 year defense) as to whether Chemstar was the old Genstar Lime Co. The failure to make that inquiry (assuming there was any doubt about it, which there had not been for 3 years) was a failure to make the most simple and obvious inquiry. Instead, there was the pronouncement (but not to Chemstar, who had to find out about it indirectly) that Chemstar was not an insured and no further defense would be offered. On these facts, it would be surprising if the jury did not find bad faith, and of course it did. To find in Liberty's motion the line that Chemstar is not an insured stirs the blood and brought forth this lengthy exposition, which, of course, is repetitive of the summary judgment order. The facts were easily available to Liberty and the necessity of pursuing them was obvious. That the facts were not inquired into (other Liberty personnel knew them but were not consulted) at a time when a large payout was imminent suggests strongly that other reasons were behind the non-defense decision.

The punitive damage finding is supported by evidence of oppression and malice as it is defined under California law (reckless disregard of the rights of others).

The repeated promises of Liberty directly to the claimants themselves that Liberty would pay their damages once it figured out what they were supports the bad faith theory.

Liberty claims that the court committed error when it excluded evidence of policy limits, retrospective premiums, and excess coverage. None of these were relevant

to the duty to defend, and pursuing them would have taken time out of all proportion to any tangential relevancy to the case being tried.

The summaries of attorney's time charges was admitted because the parties stipulated to the admission. The court does not recall a motion to set aside the stipulation. However, such would have had to be based on some excusable neglect or other like error, which has not (and was not) presented.

The punitive damage instruction was not in error, particularly considering the instructions as a whole.

The amount of punitive damages bears a reasonable relationship to the actual damages. In addition, the observation of the court was that this was a particularly intelligent and attentive jury. The factors in the case were as egregious as the court has ever seen in an insurance bad faith case in 20 years as a judge. The jury's determinations were solidly based in the evidence.

The motions for JNOV, new trial, and remittitur are denied.

2. Genstar's motion to file Third Amended Counterclaim and Cross-claim is granted. Said pleading is deemed filed and served this date. 10 days to respond.

Liberty's opposition to the new bad faith claim (that the failure to defend Chemstar is also bad faith as to Genstar) is based on the theory that bad faith will have to be relitigated. Indeed, this possibility was the reason that the court did not allow it earlier when it was too late to combine Genstar's bad faith claim with Chemstar's claim. However, the reason does not now have validity. The

jury, having found bad faith, and judgment having been entered on that verdict, the existence of bad faith is now determined and will not have to be relitigated under the principles of res judicata. Since no new litigation of the basic claim is required, the claim may now be added. If it is later determined that relitigation as to the existence of bad faith is required (i.e., if for some reason res judicata does not apply to prevent relitigation), the court reserves the power to strike the claim. Liberty reminds the court that it had previously rejected the claim, but that argument is unavailing; the reason the claim was previously rejected does not now apply. Lastly, Liberty says that the court has excluded waiver arguments. This is not so; they were only excluded from the first trial because the argument posed a coverage issue which all parties had to litigate.

3. The motion of American Home Assurance Co. for partial summary judgment on the issues of waiver and estoppel is denied.

The court is not satisfied that, in this situation, doctrines of waiver and estoppel which might possibly be invoked by Chemstar, the claimants, and Genstar are available to American Home Assurance Co. (American). Much of California law in this area has been decided for the purpose of protecting the insured against arbitrary and unreasonable action by the insurer. Not all doctrines which are invented to protect the insured should necessarily be available to an excess insurer; this should depend on the purpose of the doctrine in the first place. Thus, much of the quasi-punitive consequences of a failure to defend decided by *Gray v. Zurich* and subsequent cases should not be available to an excess insurer, since

the doctrine was conceived in an attempt to protect a policy holder who, in most situations, could not defend himself. In the first phase of this case, that has manifested itself by requiring Liberty to reimburse Chemstar for costs of defense in excess of what Liberty would have paid had it defended, in paying an amount which Chemstar had to pay to settle a claim even though coverage by Liberty of that claim was and still is in dispute, and even in requiring Liberty to pay the costs of Chemstar in obtaining a judgment for the first two items. However, as between Liberty and American, the excess carrier over Liberty, the policy of the law should be that the respective contracts of the two govern their relationship inter se, not the application of special doctrines designed to protect their mutual insured against either of them. American, in citing the *Northwestern* case as to the duty of a primary carrier to an excess carrier does not recognize a significant difference between that case and this. The duty of the primary carrier to settle within its limits if it reasonably can, said in that case to run not only to the insured, but to the excess carrier, was a holding of a duty owed to the excess by the primary. The consequences of a failure of a duty to defend an insured, however, do not necessarily run to the excess carrier since the protections necessary for the insured are not needed by the excess carrier. Thus the consequences of a breach of that duty to the insured should not necessarily be available to the excess carrier.

Here, a common consequence of failure to reserve a policy defense known (or which should be known on a reasonable investigation) is that the coverage issue may not be raised later in defense of a claim by the insured. It

is hard to see why an excess carrier should obtain the advantage of this doctrine, which, again, is designed to protect insureds. Further, if the insured, or the claimants, may rely on an insured's promise to pay the claimants, as to which the insured later reneges for after discovered policy coverage reasons, it is hard to see a policy reason for the excess carrier to have the benefit of the waiver, or estoppel, which theoretically can result. It is enough that the excess carrier obtains the benefit of the primary insurer's contract, whatever it is, rather than the benefit of doctrines of law designed to protect a party in a different position than the excess carrier.

However, here American says that it has the advantage of an assignment from Chemstar of its claims, including waiver and estoppel claims, against Liberty. There may be some doubt whether such claims are assignable, but assuming that they are, the assignment does not benefit American, since Chemstar has not been required to defend or pay claims on which American sues Liberty. Assuming, without deciding, that if Chemstar [had] been required to continue its own defense, and doctrines related to the failure of Liberty to do its duty to defend and failure to reserve its rights as to Chemstar obviated policy defenses, and Chemstar could then recover from Liberty free of policy defenses, still American is only an incidental beneficiary of that fortuity. When none of that happens, American acquires nothing by assignment from Chemstar and must rely on its own contract and Liberty's.

With these doubts about the whole theory of American's motion for summary judgment, the motion is denied. Chemstar purports to "join" in American's

motion. However, its rights are entirely different than American's rights; it is inappropriate for it to join American's motion. If the "joinder" is meant to be an assertion of its own rights vis-a-vis Liberty, it has not shown that it is bearing defense or settlement costs (over and above that for which it already has a judgment) as to which a waiver or estoppel argument could apply.

The court recognizes that it has taken a different slant than that of both parties to the motion. Put in more traditional terms, there is not a waiver of any rights as between American and Liberty, nor is there a representation of Liberty on which American relied. The obligations of one to the other should be based on an interpretation of their respective contracts of insurance.

B:902904.316

United States District Court
Central District of California
Los Angeles, California

CHEMSTAR, INC. Plaintiff vs. LIBERTY MUTUAL INSURANCE CO., et al. Defendants	Docket No. CV-90-2904-HLH Los Angeles, California March 16, 1992 11:38 a.m.

HEARING ON MOTIONS

THE HONORABLE HARRY L. HUPP PRESIDING
UNITED STATES DISTRICT COURT JUDGE

COURT RECORDER:	TRANSCRIPTION BY:
CYNTHIA MIZELL U.S. District Court	NORTHWEST TRANSCRIPTS, INC. California Division P.O. Box 2390 Monrovia, California 91017 (818) 574-1075

Proceedings recorded by electronic sound recording, transcript produced by transcription service.

* * *

[p. 19] THE COURT: I can't see it, Mr. Furnier. I'm going to deny the motion for a new trial for JNOV –

MR. FURNIER: Your Honor –

THE COURT: – for remittitur. If you want to discuss some of these other things – you stipulated to the introduction of that evidentiary item which you now complain about. My ruling admitting them was based on the stipulation so there's no point there.

MR. FURNIER: May I say –

THE COURT: You say the punitive damages are not reasonably related to the actual damages, but they were – what, six times? I've forgotten.

UNIDENTIFIED SPEAKER: Five.

THE COURT: Five; okay. Obviously the jury was paying attention to the instruction they had to be reasonably related. Here they are. I don't see what there is to do to go back to – go back to first base again. Seems to me the jury took a very realistic view of this thing.

MR. FURNIER: Your Honor –

THE COURT: Do you want to comment on any of these other items?

MR. FURNIER: Just two, Your Honor. The first is on the second page of your tentative at the bottom regarding the [p. 20] repeated promises of Liberty –

THE COURT: Yes.

MR. FURNIER: – directly to the claim. Your Honor, on the issue of punitive damages, there's supposed to be some reasonable relationship between the compensatory damages and the punitive damages.

THE COURT: Okay.

MR. FURNIER: And what exactly is the compensatory damage that Chemstar received with respect to these broken promises to the claimant? I could see if the claimants had sued Liberty Mutual based on misrepresentation or detrimental alliance [sic] or unjust – some other theory. But there's no connection between – there's no proximate cause between anything that Liberty represented to these homeowners and Chemstar's damages.

THE COURT: Well –

MR. FURNIER: Just because it comes up in the same claim –

THE COURT: No. I'm not talking about that in terms of a separate cause of action. There wasn't any damages awarded to the people to whom those representations were made except the one person who Chemstar had to pay. What I'm talking about there is that's evidence of bad faith that they would promise these people these things and then leave Chemstar holding the bag when Liberty Mutual walked away from [p. 21] their defense.

MR. FURNIER: Well, Your Honor –

THE COURT: It's just an evidentiary item.

MR. FURNIER: Well, Your Honor, how does that go to Liberty's bad faith to Chemstar? I could see how it might go to alleged bad faith claims by homeowners against Liberty. But the fact that Liberty makes representations to homeowners – to have that tried as an element of bad faith and reward Chemstar for that when Liberty Mutual didn't know that this was going to be a trial about what we said and did to the homeowners.

THE COURT: Okay. Anything else? Any other items you'd like to –

MR. FURNIER: The final one, Your Honor, is on the top of the next page dealing with the exclusion of evidence. And again, it goes back to this notion that somehow – what I believe is a misimpression that the jury had was that Liberty made the decision it did so it wouldn't have to pay a dime as to these claims and so that it wanted to avoid a liability.

THE COURT: Well, that – obviously that was Chemstar's theory –

MR. FURNIER: That's right.

THE COURT: – and the jury had to evaluate the validity of that theory.

MR. FURNIER: Well, how could it evaluate that, Your [p. 22] Honor, if it wasn't allowed to hear evidence that Liberty Mutual –

THE COURT: Because as a matter of law you had the duty to defend. Whether you had the duty to cover isn't really directly relevant on that. You had the duty to defend.

MR. FURNIER: So it's all right for Chemstar to argue that as motivation for our duty to deny a defense we wanted to avoid a forty or fifty million dollar liability, but it's not appropriate for Liberty to argue the converse that, no, that had nothing to do with our motivation. That was not our state of mind because, number one, we will continue to pay for these claims on behalf of whom we believe is our insured, the Genstar Lime Company. Number two, it's not our money that's at stake here

because of the retrospective premiums at issue. It's not only our money, and so on and so on, Your Honor. It goes to –

* * *

[p. 25] THE COURT: All right. All right. Anything else you want to comment on on the motion for a new trial or a JNOV?

MR. FURNIER: No, Your Honor. That's fine.

THE COURT: All right. The motions are denied.

**THIS CONSTITUTES NOTICE OF ENTRY
AS REQUIRED BY FRCP, RULE 77(d).**

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* UNITED STATES DISTRICT COURT

CENTRAL DISTRICT OF CALIFORNIA

(Filed Sept. 21, 1992)

(Entered Sept. 22, 1992)

CHEMSTAR, INC. an Arizona corporation, Plaintiff, v. LIBERTY MUTUAL INSURANCE COMPANY, etc., et al., Defendants.	CASE NO. 90 2904 HLH PROPOSED ORDER REGARDING NATIONAL UNION'S MOTION FOR SUMMARY JUDGMENT DATE: SEPTEMBER *21,* 1992 TIME: 10:00 A.M. DEPT: COURTROOM 7

Cross-Defendant, NATIONAL UNION'S, Motion for Summary Judgment on LIBERTY MUTUAL'S Cross-

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* Italics denotes handwritten copy.

Claim for Declaratory Relief and INDUSTRIAL INDEMNITY OF HAWAII, LTD.'S Cross-Claim for Declaratory Relief, *and Industrial Indemnity's motion for Summary Judgment against Liberty Mutual* having been heard by the court on September ~~14~~ *21*, 1992, and good cause having been shown, IT IS HEREBY ORDERED:

1. That the following material facts are found to be without substantial controversy:

a. NATIONAL UNION FIRE INSURANCE OF PITTSBURGH, PA ("NATIONAL UNION") is a primary insurer providing general comprehensive liability and commercial general liability coverage for CHEMSTAR, INC. ("CHEMSTAR") for the periods of December 5, 1986 through October 1, 1887 and October 1, 1987 through October 1, 1988, respectively.

b. LIBERTY MUTUAL INSURANCE COMPANY ("LIBERTY") is a primary insurer providing blanket liability coverage for GENSTAR LIME COMPANY and its successor, CHEMSTAR, INC., for the periods of March 15, 1984 to March 15, 1985; March 15, 1985 to March 15, 1986; and March 15, 1986 to December 5, 1986.

c. INDUSTRIAL INDEMNITY INSURANCE COMPANY OF HAWAII, LTD. ("INDUSTRIAL INDEMNITY") is an excess carrier providing coverage for CHEMSTAR, INC. pursuant to policy number JU895-2711 for the period of December 4, 1986 through December 4, 1987 which was cancelled effective October 1, 1987.

d. The plaster pitting property damage had clearly manifested by 1985 when the first homeowner claims were made.

2. That NATIONAL UNION *and Industrial Indemnity* is entitled to summary judgment for the following conclusions of law:

a. All 28 plaster pitting claims for property damage asserted against GENSTAR and CHEMSTAR arose from a single occurrence.

b. The general liability policies issued by NATIONAL UNION *and Industrial Indemnity* provide no coverage for any of the plaster pitting claims.

c. NATIONAL UNION *and Industrial Indemnity* hasve no obligation to reimburse LIBERTY MUTUAL for any costs incurred by LIBERTY MUTUAL in the defense or settlement of any plaster pitting claim.

3. Cross-defendant, NATIONAL UNION'S *and Industrial Indemnity's* Motions For Summary Judgment ~~is~~ *are* granted and judgment ~~is~~ *will be* entered *at the conclusion of phase II* in favor of NATIONAL UNION *and Industrial Indemnity* on LIBERTY MUTUAL INSURANCE COMPANY'S Third Amended Complaint and Counter-Claim for Interpleader to Include Cross-Claims and Counter-Claims for Declaratory Relief with a Jury Demand filed on or about October 1, 1991.

4. Cross-Defendant, NATIONAL UNION'S Motion for summary Judgment is granted and judgment ~~is~~ *will be* entered *at the conclusion of phase II* in favor of NATIONAL UNION on INDUSTRIAL INSURANCE COMPANY OF

HAWAII, LTD.'s Cross-Claim for Declaratory Relief filed on or about June 25, 1990.

Date: September 21, 1992

/s/ Harry Hupp
Judge of the U.S. District Court

PROOF OF SERVICE

STATE OF CALIFORNIA, COUNTY OF ORANGE

I am employed in the County of Orange, State of California. I am over the age of 18 and not a party to the within action; my business address is 1120 West La Veta Avenue, Suite 700, Orange California, 92668.

On the date below, I served the foregoing described document as

- PROPOSED ORDER REGARDING NATIONAL UNION'S MOTION FOR SUMMARY JUDGMENT

On the interested parties in this action by placing a true copy thereof enclosed in a sealed envelope addressed as follows:

PLEASE SEE ATTACHED MAILING LIST.

I caused such envelope with postage thereon fully prepaid to be placed in the United States mail at Orange, California.

I am "readily familiar" with firm's practice of collection and processing correspondence for mailing. It is deposited with U.S. postal service on that same day in the ordinary course of business. I am aware that on motion of

party served, service is presumed invalid if postal cancellation date or postage meter date is more than 1 day after date of deposit for mailing in affidavit.

Executed this 19th day of August, 1992.

I declare that I am employed in the office of a member of the bar of this court at whose direction the service was made.

/s/ Betty A. Harness
Betty A. Harness

CHEMSTAR, INC. V. LIBERTY MUTUAL INSURANCE COMPANY

FEDERAL PROOF OF SERVICE

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UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

CHEMSTAR, INC., Plaintiff, vs. LIBERTY MUTUAL INSURANCE COMPANY, et al., Defendants, and GENSTAR CORPORATION, Interpleaded Defendant, AND RELATED CLAIMS	Case No.: 90 2904 HLH (BX) THIS CONSTITUTES NOTICE OF ENTRY AS REQUIRED BY FRCP, RULE 77(d) PHASE II FINAL DECLARATORY JUDGMENT ORDER (Filed Mar. 8, 1993) (Entered Mar. 10, 1993)

Now comes the Court and enters its **PHASE II FINAL DECLARATORY JUDGMENT ORDER,** declaring the rights and duties of the parties regarding issues of insurance coverage for the 28 underlying plaster-pitting claims and related matters as raised by the respective pleadings filed in this case.

Issues between certain parties were tried and determined in Phase I of this case as reflected in the Phase I "Judgment On Special Jury Verdict" filed February 10,

1992 and entered on February 13, 1992 as a final judgment. This **PHASE II FINAL DECLARATORY JUDGMENT ORDER** pertains to the issues of the case which the Court has found to have survived Phase I.

The parties to Phase II of this case and the insurance policies at issue are as follows:

PARTIES	POLICIES
Chemstar, Inc. ("Chemstar," the insured).	N/A
Liberty Mutual Insurance Company ("Liberty Mutual," a primary carrier).	RG1-621-004110-414, issued for the period 3/15/84 to 3/15/85 (the "'84 period"). RG1-621-004110-415, issued for the period 3/15/85 to 3/15/86 (the "'85 period"). RG1-621-004110-416, issued for the period 3/15/86 to 4/15/87 (the "'86 period") and later extended to 4/15/88.
National Union Fire Insurance Company of Pittsburgh, PA ("National," a primary carrier).	GLA 116 93 22, issued for the period 12/04/86 to 12/04/87 (the "'86-'87 period") but cancelled effective 10/01/87. GL 116 93 92 RA, issued for the period 10/01/87 to 10/01/88 (the "'87 period").
American Home Assurance Company ("American Home," an excess carrier).	920-91-36, an excess policy issued for the period 3/15/84 to 3/15/85 (the "'84 period"). 633-13-56, an umbrella (first excess) policy also issued for the '84 period. 633-13-57, an umbrella (second excess) policy also issued for the '84 period. 920-91-88, issued for the period 3/15/85 to 3/15/86 (the "'85 period").
Employers Insurance of Wausau ("Wausau," an excess carrier).	2736-00-570240, issued for the period 3/15/85 to 3/15/86 (the "'85 period").
United Insurance Company ("United," an excess carrier).	157096, issued for the period 3/15/85 to 3/15/86 (its "'85 period"). 157122, issued for the period 4/15/86 to 4/15/87 (its "'86 period).
Industrial Insurance Company of Hawaii, Ltd. ("Industrial," an excess carrier).	JU 895-2711, issued for the period 12/04/86 to 10/01/87 (its "'86-'87 period").

The issues of Phase II as raised by the parties' pleadings include:

1. Whether the 28 underlying plaster-pitting claims arose from one or more than one occurrence;

2. When coverage for the underlying claims is triggered and which parties have the burden of proof regarding certain of the involved issues;

3. Whether and to what extent insurance coverage is and will be triggered under one or more of the various polices [sic] at issue;

4. How certain of the policies' limits are to be applied;

5. Whether waiver, estoppel, equitable subrogation, assignment or promissory estoppel are applicable regarding issues between American Home and Liberty Mutual;

6. Whether National Union has a duty to contribute pro rata or otherwise to Liberty Mutual for the costs of defense of the underlying claims; and

7. How the claims are to be reallocated for coverage under the appropriate policy(ies) based upon the Court's Phase II determinations.

This **PHASE II FINAL DECLARATORY JUDGMENT ORDER** is made in accordance with all of the Court's prior determinations on Phase II issues, all of which are incorporated herein by reference, and is intended to declare the parties' duties under the Court's various Phase II rulings, including without limitation: (1) the ruling on motions regarding "occurrence," "trigger" and certain duty to defend obligations, *dated July 23, 1992;*

(2) the ruling on motions regarding the summary judgment dismissal of two of the insurer defendants, *dated September 21, 1992,;* (3) the ruling regarding Liberty Mutual's motion on exhaustion issues and its payment of $2.0 million in indemnity coverage on underlying claims as of April 17, 1991, *dated October 26, 1992;* (4) the rulings on motions regarding certain waiver, estoppel and related claims asserted by American Home against Liberty Mutual, *dated March 16, 1992, July 27, 1992 and December 21, 1992;* (5) the findings made pursuant to the Phase II-A non-jury trial regarding the policy period during which the first manifestation of plaster-pitting property damage occurred in any one of the 28 underlying claimants' homes, *dated January 29, 1993;* and (6) the status conference ruling regarding reallocation of the underlying claims previously assigned and/or paid under Liberty Mutual's '84 and '86 policies to its '85 policy, *dated February 1, 1993.* While this order pertains to all of the 28 claims, because the specific settlement and defense expenses incurred by Chemstar relating to the underlying *Friedman* claim were included in the Phase I "Judgment On Special Jury Verdict," those amounts are not included in this ORDER.

Based upon all of the Phase II rulings and determinations previously made, the Court does hereby **ORDER, ADJUDGE AND DECREE:**

1. In Phase II the factual issue regarding when the first manifestation of plaster-pitting occurred in the first of the underlying claims was narrowed by the Court's July 23, 1992 rulings on the "occurrence" and "trigger" issues to whether first manifestation occurred during the March 15, 1984 to March 15, 1985 period (the " '84

period") or during the March 15, 1985 to March 15, 1986 period (the " '85 period"). That issue was the subject of a non-jury trial conducted January 12 and 13, 1993 pursuant to which the Court held that, since it is undisputed that plaster-pitting occurred between March 15, 1985 and March 15, 1986, the insurers seeking to establish that a loss had occurred at an earlier date, *i.e.*, prior to March 15, 1985, had the burden of proof with respect to establishing the affirmative of that fact. Because the Court found that those insurers failed to carry the burden of proving that first manifestation occurred during the '84 rather than the '85 period, the Court holds that coverage for the underlying claims is to be provided under the policies issued for the '85 period, which include:

- Liberty Mutual's primary level policy, RG1-621-004110-415;
- American Home's umbrella (excess) policy, 920-91-88;
- Wausau's excess policy, 2736-00-570240; and
- United's excess policy, 157,096.

Because the policies on the risk for the '85 period are responsible for all of the plaster-pitting claims, defense costs and indemnity amounts relating to such claims paid by insurers may be reallocated to the '85 policy period.

2(a). Liberty Mutual's '85 policy has a $2.0 million each occurrence limit which, *on or about** April 17, 1991, Liberty Mutual exhausted by payment of $2.0 million in indemnity for various of the underlying claims.

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*Italics denotes handwritten copy.

2(b). Except as to certain claims by Chemstar referenced below, Liberty Mutual's obligations to provide insurance coverage (defense or indemnity) for the underlying claims under its '85 policy terminated upon exhaustion of the applicable each occurrence limit as of April 17, 1991 and, accordingly, Liberty Mutual has no further obligation under its '85 policy for insurance coverage for the underlying claims. *This paragraph is subject to the exceptions set forth in paragraph 10, as to which the court reserves jurisdiction.*

2(c). Because of a stipulation and order dismissing, without prejudice, claims between Chemstar and Liberty Mutual which remained after the Phase I judgment, referenced in ¶ 10 below, the declaration and rulings relating to exhaustion of Liberty Mutual's '85 policy are not binding on Chemstar.

3. American Home's '85 policy is the excess policy over Liberty Mutual's '85 policy, and it has each occurrence and aggregate limits of $5.0 million. Liberty Mutual's insurance coverage obligations regarding the underlying claims terminated as of April 17, 1991. American Home's '85 policy is obligated, subject to exhaustion of its applicable policy limits, for the defense costs for the underlying claims which it has incurred since April 17, 1991, *and* for the defense costs it may yet incur *all in accord with the terms of the American Home policies.*

4. The Court makes no declaration regarding coverage of the underlying claims under American Home's three policies issued for the '84 period, having determined that issues of such coverage are between and among American Home, Wausau and United and are not ripe for adjudication. American Home's '85 policy limit has not been exhausted *as of date of judgment.* Neither

does the Court make any declaration regarding coverage of the underlying claims under policies not at issue in this case which may be claimed by the insureds as providing additional or alternative coverage or which may be the basis of claims by parties-insurers for contribution or other reimbursement for the coverage provided or to be provided by them pursuant to this **ORDER.**

5. Wausau's '85 policy is the excess policy over American Home's '85 policy and it has per occurrence and aggregate limits of $5.0 million. At such time as the applicable limits of American Home's '85 policy may be exhausted, Wausau's '85 policy is obligated for defense and indemnity of the underlying claims beyond the $2.0 million already paid by Liberty Mutual and such additional amounts as have been or may be paid under the available limits of American Home's '85 policy; subject to exhaustion of Wausau's applicable policy limits in accordance with the terms of that policy and subject to coverage for the underlying claims, if any is applicable, as may exist under policies other than the '85 policies at issue in this case.

6. United's '85 policy is the excess policy over Wausau's '85 policy and it has per occurrence and aggregate limits of $10 million. At such time as the applicable limit of Wausau's '85 policy and the applicable limits of any other collectible insurance may be exhausted, United's policy is obligated for defense and indemnity of the underlying claims beyond the $2.0 million already paid by Liberty Mutual and such additional amounts as have been or may be paid under the available limits of American Home's and Wausau's '85 policies; subject to exhaustion of United's applicable limits in accordance with the

terms of that policy and subject to coverage for the underlying claims, if any is applicable, under policies other than the '85 policies at issue in this case.

7. All claims and issues as between Genstar Corporation and Wausau are dismissed without prejudice in accordance with the stipulation of the parties approved and filed April 29, 1992.

8. All claims and issues as between Genstar Corporation and American Home are dismissed without prejudice in accordance with the stipulation of the parties approved and filed May 20, 1992.

9. All claims and issues as between Genstar Corporation and Liberty Mutual are dismissed with prejudice in accordance with the stipulation of the parties approved and filed July 1, 1992.

10. With respect to issues between Chemstar and Liberty Mutual which remained after the Phase I judgment this Court entered an Order on October 30, 1992 on a stipulation between Chemstar and Liberty Mutual dismissing, without prejudice, those remaining claims, except for declaratory relief claims to determine when damage first occurred in the underlying plaster claims, with the Court reserving jurisdiction to reinstate such claims if the Phase I judgment is not affirmed in its entirety. The dismissal was subject to each party's right to reinstate its respective claims *(including Chemstar's claim of waiver and estoppel against Liberty Mutual)* in the event that the Phase I judgment is not affirmed in its entirety; further, the dismissal did not affect the rights of Chemstar and Liberty Mutual to appeal any rulings in Phase II, or to participate in proceedings relating to the date of

first manifestation. Phase II issues as between Chemstar and Liberty Mutual are dismissed without prejudice in accordance with the stipulation of the parties approved and entered October 30, 1992.

11. All of American Home's claims against Liberty Mutual under theories of waiver, estoppel, equitable subrogation, assignment and promissory estoppel are dismissed with prejudice in accordance with the Court's ruling dated December 21, 1992.

12. *National Union has no indemnity obligation under its '86 and '87 policies based on the determination that coverage is under the Liberty Mutual '85 policy.* National Union's '86-'87 and '87 policies were triggered for defense of all of the underlying claims, as were all of Liberty Mutual's, upon the Court's finding that there was a potential for coverage under those policies. Although National Union originally owed a duty to defend to Chemstar under its '86-'87 policies, because of the Court's decision on the "occurrence" and "trigger" issues which precluded coverage of any of the plaster-pitting claims under National Union's policies, National Union has no duty to contribute to Liberty Mutual for any defense costs nor does it have any duty to share pro rata in the defense obligations.

13. Industrial has no obligation under its '86-'87 excess policy, or otherwise, for defense or indemnity for the underlying claims upon the Court's determination that the underlying property damage triggers coverage under policies issued for the '85 period (3/15/85 to 3/15/86) and not policies issued thereafter. (Order filed September 21, 1992.)

14. The Court finds there is no just reason for delay and pursuant to Rule 54(b) of the Federal Rules of Civil Procedure directs that the foregoing be entered as a final judgment. However, the Court reserves jurisdiction to consider American Home's motion, should it have filed one on or before February 11, 1993, for leave to amend its pleadings to allege a claimed violation of good faith and fair dealing duties argued as owed to it.

SO ORDERED.

Date:
March 8, 1993

/s/ Harry L. Hupp
Harry L. Hupp, Judge
United States District Court
Central District of California

This form of final judgment was prepared pursuant to the Court's 02/01/93 status conference request, by:

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UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

CHEMSTAR, INC., Plaintiff/Appellee v. LIBERTY MUTUAL INSURANCE COMPANY Defendant/Appellant.	Appeal No.93-55555 consolidated with Nos. 93-55557, 93-55558, 93-55560, 93-55561 and 92-55472 DC No.: CV-90-2904-HLH Central California

OPENING BRIEF OF RESPONDENT AND CROSS-APPELLANT LIBERTY MUTUAL INSURANCE COMPANY

On Appeal from the United States District Court
For the Central District of California
The Honorable Harry L. Hupp
Numbered Therein CV-90-2904-HLH

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PLASTER-PITTING CLAIMS PER PERIOD UNDER LIBERTY'S ONE OCCURENCE, MULTIPLE TRIGGER (MANIFESTATION) POSITION

INSURANCE AND LIMITS

*	UNITED $5.0 M	*	SALE OF GLC DECEMBER 5 1986	*	*
AMERICAN HOME $5.0 M	WAUSAU $5.0 M			*	*
AMERICAN HOME/ KANSA* $5.0 M	AMERICAN HOME $5.0 M	UNITED $5.0 M		INDUSTRIAL $1.0 M/occ. $1.0 M/agg.	*
LIBERTY $2.0 M/occ. $2.0 M/agg.	LIBERTY $2.0 M/occ. $5.0 M/agg.	LIBERTY $2.0 M/occ. $5.0 M/agg.		NATIONAL UNION $1.0 M/occ. $1.0 M/agg.	NATIONAL UNION $1.0 M/occ. $1.0 M/agg.
3/15/84 - 3/15/85	3/15/85 - 3/15/86	3/15/86 - 12/05/86		12/05/86 - 10/01/87	10/01/87 - 10/01/88
GENSTAR				**CHEMSTAR**	
2 CLAIMS** KAZARIAN DIAMOND	6 CLAIMS** FUNKHOUSER WISDA KRASNE NODAY SPECK THORPE	9 CLAIMS** DAVIS GUELFF WELLS TRUJILLO PEIRPOINT RUBIN CULVER AREA MELLOS		7 CLAIMS** FRIEDMAN PLOCKEY CRUMPLER MCMILLAN LIEBOWITZ RACHT CRANE	4 CLAIMS** COOPER BOZULICH WILLOCK MELDRUM
	28 CLAIMS TRIGGERED PER DISTRICT COURT DECISION				

* Not a party to this action.

** Evidence of record as to when damage occurred in each home was not developed because the trial court decided the manifestation date issue as to all claims based upon one date -- the time of first manifestation of damage in the first home -- albeit erroneously even as to that date. The claims are placed on the above time line based upon the dates in Exhibit A to Liberty's "Third Amended Answser ..." served October 1, 1991 (CR 288), and with respect to the Diamond and Funkhouser claims, only, in accordance with further facts developed at and for trial.

RC1\108296.\JM

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

CHEMSTAR, INC., Plaintiff/Appellee v. LIBERTY MUTUAL INSURANCE COMPANY Defendant/Appellant.	No. 92-55472 DC No.: CV-90-2904-HLH Central District California

OPENING BRIEF OF APPELLANT LIBERTY MUTUAL INSURANCE COMPANY

On Appeal from the United States District Court
For the Central District of California
Numbered Therein CV-90-2904-HLH

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	May 1986	August 28, 1986	September 18, 1986	October 1, 1986	Dec 1, 1986
Genstar/ Liberty Mutual Chronology	Liberty Mutual [insurer] Genstar (parent corp) Flintkote (A subsidiary of Genstar. It owns all Lime assets.) GLC (The lime division of Flintkote) L.M. issued policy to Genstar on March 15, 1986	Liberty Mutual [insurer] Genstar (parent corp) Flintkote (A subsidiary of Genstar. It owns all Lime assets.) GLC (formerly a division of Flintkote, it is made a wholly owned subsidiary of Flintkote.) GLC prepares to be sold. It is made a subsidiary.	Liberty Mutual [insurer] Genstar (parent corp) Flintkote (A subsidiary of Genstar.) GLC (subsidiary of Flintkote)	Liberty Mutual [insurer] Genstar (parent corp) Flintkote (A subsidiary of Genstar. It sells its lime assets to GLC.) GLC (subsidiary of Flintkote.) It puchased Flintkote's lime assets on September 30, 1986.	Liberty Mutual [insurer] Genstar (Parent Corp) Flintkote (Subsidiary) GLC (subsidiary that now owns all the lime Assets)
Chemstar Chronology	Not in existence	Not in existence Individuals forming a corp. to buy GLC	Newco is incorporated Newco is created to Purchase GLC.	Newco STOCK PURCHASE AGREEMENT Newco assumes all liabilities of GLC and agees to indemnify and hold Flintkote and affiliates harmless for all liability arising from GLC activities.	Newco changes it name to: Chemstar Inc. Nevada Corp.
Claims	Krasne, Noday, and Diamond claims made				

	Dec 5, 1986	Dec 15, 1886	Jan 13, 1987	Sept. 30, 1988
Genstar/ Liberty Mutual Chronology	Liberty Mutual [insurer] Genstar (Parent Corp) Flintkote (Subsidiary of Genstar) COMPLETION OF SALE OF GLC GLC DELETED FROM COVERAGE	Liberty Mutual [insurer] Genstar (Parent Corp) Flintkote (Subsidiary of Genstar)	Liberty Mutual [insurer] Genstar (Parent Corp) Flintkote (Subsidiary of Genstar)	Genstar (parent corp) Flintkote (subsidiary of Genstar)
Chemstar Chronology	National Union [insurer] Chemstar, Inc. (parent corp.) GLC (Subsidiary of Chemstar, Inc. It owns the lime assets) Chemstar, Inc. purchase of GLC completed. Purchases its own liability insurance policy.	National Union [insurer] Chemstar, Inc. (parent corp.) Chemstar Lime Co. (subsidiary of Chemstar. Formerly named GLC.) GLC's name is changed to Chemstar Lime Co. since Chemstar did not own the rights to the name "Genstar"	National Union [insurer] Chemstar, Inc. Delaware Corp. Chemstar, Inc. & Chemstar Lime Co. merge. This is the date GLC becomes Chemstar, Inc.	Chemstar Inc. Delaware Corp. CAN-AM (An Arizona Corp.) MERGER Chemstar, Inc. Arizona Corp
Claims			Friedmans move into home in January. Notice plaster pitting after moving in.	

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

CHEMSTAR, INC., Plaintiff-Appellee, v. LIBERTY MUTUAL INSURANCE COMPANY, Defendant-Appellant, and GENSTAR CORPORATION; NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA.; INDUSTRIAL INSURANCE COMPANY OF HAWAII, LTD.; AMERICAN HOME ASSURANCE COMPANY; EMPLOYERS INSURANCE OF WAUSAU, Defendants.	No. 92-55472 D.C. No. CV-90-2904-HLH (Filed Dec. 28, 1994)
CHEMSTAR, INC., Plaintiff-Appellee, v. LIBERTY MUTUAL INSURANCE COMPANY, Defendant-Appellant, and	No. 93-55555 D.C. No. CV-90-02904-HLH

GENSTAR CORPORATION; NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA.; INDUSTRIAL INSURANCE COMPANY OF HAWAII, LTD.; AMERICAN HOME ASSURANCE COMPANY; EMPLOYERS INSURANCE OF WAUSAU, UNITED INSURANCE,

Defendants.

CHEMSTAR, INC.,

Plaintiff-Appellant,

v.

LIBERTY MUTUAL INSURANCE CO.; GENSTAR CORPORATION; NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA.; INDUSTRIAL INSURANCE COMPANY OF HAWAII, LTD.; AMERICAN HOME ASSURANCE COMPANY; EMPLOYERS INSURANCE OF WAUSAU; UNITED INSURANCE,

Defendants-Appellees.

No. 93-55557

D.C. No. CV-90-02904-HLH

CHEMSTAR, INC.,

Plaintiff-Appellee,

v.

LIBERTY MUTUAL INSURANCE CO.; GENSTAR CORPORATION; NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA.; INDUSTRIAL INSURANCE COMPANY OF HAWAII, LTD.; AMERICAN HOME ASSURANCE COMPANY; EMPLOYERS INSURANCE OF WAUSAU,

Defendants,

and

UNITED INSURANCE,

Defendant-Appellant.

No. 93-55558

D.C. No. CV-90-02904-HLH

CHEMSTAR, INC.,

Plaintiff-Appellee,

v.

LIBERTY MUTUAL INSURANCE CO.; GENSTAR CORPORATION; NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA.; INDUSTRIAL INSURANCE COMPANY OF HAWAII, LTD.; AMERICAN HOME ASSURANCE COMPANY; UNITED INSURANCE,

Defendants,

No. 93-55560

D.C. No. CV-90-02904-HLH

and

EMPLOYERS INSURANCE OF WAUSAU,

Defendant-Appellant.

CHEMSTAR, INC.,

Plaintiff-Appellee,

v.

LIBERTY MUTUAL INSURANCE CO.; GENSTAR CORPORATION; NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA.; INDUSTRIAL INSURANCE COMPANY OF HAWAII, LTD.; EMPLOYERS INSURANCE OF WAUSAU; UNITED INSURANCE,

Defendants,

and

AMERICAN HOME ASSURANCE COMPANY,

Defendant-Appellant.

No. 93-55561
D.C. No.
CV-90-02904-HLH

ORDER

Before: O'SCANNLAIN, FERNANDEZ, and T.G. NELSON, Circuit Judges.

The applications of Genstar Pacific Corp., et al. and Atlantic Richfield Co., et al. to file amici petitions for rehearing and suggestions for rehearing en banc are DENIED.

The application of Atlantic Richfield Co., et al. to file a rsponse [sic] to Liberty Mutual's 28(j) letter is DENIED.

Wausau's petition for rehearing is DENIED.

The panel has voted to deny Liberty Mutual's petition for rehearing and to reject its suggestion for rehearing en banc.

The full court has been advised of the en banc suggestion, and no judge of the court has requested a vote on it.

The petition for rehearing is DENIED and the suggestion for rehearing en banc is REJECTED.

Supreme Court, U.S.
FILED
MAR 8 1995
OFFICE OF THE CLERK

No. 94-1337

IN THE
Supreme Court of the United States
OCTOBER TERM, 1994

LIBERTY MUTUAL INSURANCE CO.,
Petitioner,

v.

CHEMSTAR, INC. AND NATIONAL UNION FIRE INSURANCE CO. OF PITTSBURGH, PA.,
Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

---

BRIEF IN OPPOSITION

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COUNTERSTATEMENT OF THE QUESTIONS PRESENTED

1. Whether the district court's exercise of its discretion under Fed. R. Civ. P. 42(b), to bifurcate trial in a diversity suit concerning an insurer's duty to defend under state law violated *Erie R. Co. v. Tompkins*, 304 U.S. 64 (1938), and the Rules Enabling Act.

2. Whether the imposition of punitive damages against an insurance company violated the Due Process Clause where the award (i) was based on clear and convincing evidence that the defendant acted with fraud, oppression or malice; (ii) was limited to five times the amount of compensatory damages; (iii) constituted less than two-thirds of one percent of the defendant's policyholder surplus; and (iv) was fully reviewed by the district court and the Ninth Circuit Court of Appeals and affirmed by both courts in written decisions.

PARTIES

Respondent Chemstar, Inc. was the plaintiff below and is a corporation whose parent and affiliated companies have not issued shares to the public. The following parties appeared by way of Chemstar's complaint or third party claims: Liberty Mutual Insurance Company; National Union Fire Insurance Company of Pittsburgh, Pennsylvania; Industrial Insurance Company of Hawaii LTD.; Genstar Corporation; American Home Assurance Company; Employer's Insurance of Wausau; and United Insurance Company.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1994

No. 94-1337

LIBERTY MUTUAL INSURANCE CO.,
Petitioner,

v.

CHEMSTAR, INC. AND NATIONAL UNION FIRE INSURANCE CO. OF PITTSBURGH, PA.,
Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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BRIEF IN OPPOSITION

Respondent Chemstar, Inc. ("Chemstar") submits this brief in opposition to Liberty Mutual Insurance Company's ("Liberty") Petition for Writ of Certiorari.

STATEMENT OF THE CASE [1]

Petitioner seeks review of one of three decisions by the United States Court of Appeals for the Ninth Circuit affirming the trial court's disposition of a diversity action, applying state law, involving an insurance coverage dispute with an insurer. The case arose out of the bad

[1] This Statement is limited to a discussion of the facts relevant to the petition now before the Court and does not attempt a complete description of the trial proceedings below. In the interest of brevity, Chemstar also incorporates by reference the statement of the facts in the main opinion below, set forth at Pet. App. 8a-10a.

faith denial of a defense by Liberty in dozens of property damage claims brought against Chemstar. The district court found Liberty's conduct to be unprecedented. As the district court stated: "The factors in the case were as egregious as the court has ever seen in an insurance bad faith case once in 20 years as a judge." (Pet. App. 79a)[2]

Following extensive pre-trial discovery, the district court granted summary judgment against Liberty holding, on the basis of undisputed facts, that Liberty had a duty to defend Chemstar under well-settled California law. (Pet. App. 60a-62a) After a subsequent jury trial, judgment was also entered upon special verdict findings that Liberty breached its duty of good faith and fair dealing to Chemstar, and acted with oppression, fraud or malice, in completely withdrawing from the defense of Chemstar in numerous property damage cases. Based on these findings, the jury awarded Chemstar actual and compensatory damages of approximately $2.8 million and punitive damages of $14 million. (Pet. App. 68a-71a)

The district court reviewed the entire record in denying Liberty's motion for a new trial, and found that the jury's determinations "were solidly based in the evidence." (Pet. App. 79a) The court of appeal likewise reviewed the entire record and unanimously affirmed the judgment. (Pet. App. 26a) Liberty now challenges that decision.

Factual Background

This diversity action arose out of 28 claims brought by homeowners in Southern California against Chemstar. Those homeowners alleged that lime manufactured and sold by Genstar Lime Company ("Genstar Lime"), Chemstar's predecessor, was defective and resulted in property damage to their homes. (Pet. App. 8a-9a) Genstar Lime gave notice of the first plaster claims to Liberty in July 1986, during the period of its comprehensive general liability insurance policies with Liberty. After Genstar

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[2] Citations to "Pet. App. ——" refer to the Appendix to the petition for writ of certiorari filed by Liberty.

Lime was sold and merged into Chemstar, Chemstar continued to give notice of the plaster pitting claims to Liberty. (SUPP 108, 135)[3]

For three years Liberty defended the claims and never issued a reservation of rights. However, in 1989 Liberty abruptly withdrew from the defense of all plaster cases against the recommendation of its own claims personnel. (SUPP 50, 216) At trial, Liberty contended that it had just found out about the sale and merger of Genstar Lime into Chemstar, and that Chemstar did not qualify as an insured under the Liberty policies. These contentions were directly contradicted by oral and documentary evidence, including the following:

1. The trial record was replete with written evidence of Liberty's awareness of its obligations to defend Chemstar. Liberty sent Special Claims Service instructions to every Liberty office. Those instructions made clear that Liberty was aware of the sale of Genstar Lime to Chemstar and was aware of its responsibility to defend Chemstar. (SUPP 2)

2. Liberty's principal witness, Frank Overman ("Overman"), admitted at trial that the plaster claims constituted a single occurrence which began during Liberty's coverage. (RT 1479-80; SUPP 201) Nevertheless, Liberty withdrew its defense in any and all plaster claims, violating Liberty's own Special Claims Service instructions.

3. Liberty had settled one early plaster case for nearly $1 million. This settlement required approval at the highest levels of Liberty's senior management and took place after Liberty's Home Office examiner had analyzed the policy and concluded that Chemstar qualified as "an insured entity." (SUPP 72) Yet Overman never even

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[3] SUPP refers to Chemstar's supplemental excerpts of record submitted with its briefing in Phase I of the appeal in the Ninth Circuit. EOR refers to Liberty's excerpts of record submitted with its briefing in Phase I. RT signifies the Reporter's Transcript from the Phase I trial, and CR signifies the clerk's record.

spoke to the examiner before he withdrew the defense from Chemstar. (RT 1420; SUPP 224)

4. The attorney retained by Liberty to defend Chemstar advised Liberty that "Chemstar, Inc. is in fact the successor-in-interest of Genstar Lime" and recommended that Chemstar be defended. (SUPP 105) Liberty ignored the recommendation.

5. Liberty disregarded the recommendations of its regional claims specialist, William Durcho, who wrote to the Home office that Liberty should continue to defend Chemstar. (SUPP 50, 57) Overman did not even attempt to contact Durcho to discuss this recommendation. (RT 261, 1409-1411; SUPP 190, 214)

6. Before withdrawing its defense, Liberty did not give Chemstar any prior warning so that Chemstar could at least submit information to demonstrate its right to a defense. (RT 1473; SUPP 199) As the district court noted, Liberty failed to make even the most simple and obvious inquiry. (Pet. App. 78a)

7. Liberty never issued a reservation of rights letter to Chemstar. Nevertheless, after investigating and defending the plaster claims for three years, Liberty did not even communicate its withdrawal decision directly to Chemstar, but left Chemstar to fend for itself with no explanation as to why Liberty had suddenly reversed its position. (Pet. App. 78a)

8. Liberty repeatedly advised the homeowners in writing that Liberty would pay all reasonable and necessary expenses required to repair their homes. (Pet. App. 78a) After three years of these promises, Liberty abruptly withdrew from the defense, leaving Chemstar to face numerous angry homeowners who vented their frustrations on Chemstar by filing suits for compensatory and punitive damages. When asked about the impact on Chemstar, Overman replied it was "pretty obvious." (RT 1475-76; SUPP 225-26)

Liberty's conduct represented an especially flagrant violation of its duties to its insured. In denying Liberty's post-trial motions, the district court stated, "On these facts it would be surprising if the jury did not find bad faith, and of course it did." (Pet. App. 78a)

Procedural History

Chemstar filed this action in Los Angeles Superior Court on March 13, 1990, alleging claims for breach of contract, breach of the covenant of good faith and fair dealing, and declaratory relief against Liberty. Chemstar also brought a claim for declaratory relief against another primary insurer and an excess insurer. Liberty removed the action to the United States District Court for the Central District of California on the basis of diversity of citizenship. (CR 1, 1-4)

In November, 1990, Liberty then filed a third-party complaint (CR 66) which resulted in three more insurance companies being drawn into the action, two of which moved to vacate the dates for the discovery cut-off and the pre-trial conference. (CR 97, 116, 124) The district court scheduled a new status conference to discuss a revised trial schedule. (CR 184) Thereafter, at the status conference, Chemstar requested a separate trial on the duty to defend issues, to the extent they were not resolved on summary judgment. (RT 7/22/91 at 64-65) With the exception of Liberty, all insurers agreed with Chemstar's request for a bifurcated trial. The district court then bifurcated the duty to defend issues between Liberty and Chemstar from the remainder of the case. (Pet. App. 57a-58a; RT 7/22/91 at 76; CR 234)

Under the trial court's bifurcation order, the first phase of the lawsuit ("Phase I") involved the application of settled principles of California law to issues relating to Liberty's duty to defend Chemstar under the comprehensive general liability insurance policies. The second phase of this action ("Phase II") involved the separate and dis-

tinct issues regarding ultimate indemnification obligations of Liberty and other insurers under California law for the property damage claims.

Prior to the trial of Phase I, the district court granted Chemstar's motion for summary judgment and ordered that: (i) Liberty had a duty to defend Chemstar against all of the underlying plaster claims, because there was a *potential* for indemnification coverage under the Liberty policies; and (ii) Liberty breached its duty to defend Chemstar by abandoning the defense of the plaster claims. (Pet. App. 59a-62a)[4] With respect to Chemstar's bad faith claim, the district court denied the motion and set the matter for trial. Following ten days of trial, the jury then determined that, in failing to defend, Liberty had breached its duty of good faith and fair dealing toward Chemstar, and returned a special verdict awarding Chemstar $2,790,966 in compensatory damages. (Pet. App. 68a-71a) The jury also found that Liberty had acted with oppression, fraud or malice, and awarded punitive damages in the amount of $14 million. (Pet. App. 70a-71a)

After the jury verdict was returned, Liberty filed a motion for judgment NOV, for new trial, or for remittitur as to the Phase I trial. (Pet. App. 75a) The district court ruled that the jury's finding of a bad faith breach of the duty to defend was supported by sufficient evidence, that the punitive damage award was supported by sufficient evidence of oppression, fraud or malice as defined under California law, and that the amount of punitive damages bore a reasonable relationship to the actual damages. (Pet. App. 75a-80a)

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[4] As part of these rulings, the district court also held that Chemstar was the successor to Genstar Lime, an insured under the Liberty policies, and was therefore entitled to the same rights and benefits as Genstar Lime under the Liberty policies. (Pet. App. 60a)

The Court of Appeals' Decisions

On appeal, the Ninth Circuit unanimously affirmed the Phrase I judgment in its entirety. The court of appeals fully considered every issue raised by Liberty, and held, *inter alia*, that substantial evidence supported the district court's conclusion that Liberty had a duty to defend all plaster claims because the claims created the *potential* for coverage under Liberty's policies. (Pet. App. 27a-30a) The court also ruled that the bifurcation order was proper and "greatly helped simplify a legally complicated and issue-intensive case and did not separate intertwined issues so as to create confusion and uncertainty." (Pet. App. 31a) In addition, the court reviewed the record again and found that substantial evidence supported the jury's findings that Liberty had acted in bad faith and that its conduct justified punitive damages. The court further ruled that the punitive damages were not "excessive" or "grossly disproportionate." (Pet. App. 40a)

In separate opinions, the court of appeals also affirmed the district court's judgment in Phase II, which determined indemnification liability to Chemstar and contribution and other equitable issues among Chemstar's various primary and excess insurers. The lower courts determined that Liberty and other insurers whose policies were in effect at the date of the first manifestation of property damage were responsible for the indemnification of all the third-party claims.[5] The courts also determined that Liberty

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[5] The Phase II rulings included the following: (1) that the 28 claims constituted a single "occurrence" under the insurance policies; and (2) that a "manifestation" trigger of coverage applied to the claims, so that the policies in effect between March 15, 1985 and March 15, 1986 were obligated for the defense and indemnity of all plaster claims. (Pet. App. 14a, 18a) The court also ruled that Liberty's March 15, 1985 to March 15, 1986 policy was exhausted on April 17, 1991. However, that ruling did not apply to Chemstar because Liberty and Chemstar had entered into a stipulation which provided that "[a]ny ruling [on exhaustion] shall not be considered, introduced or used in any way by Liberty

had no right to contribution from National Union, another primary insurer. (Pet. App. 48a, 104a) Liberty's petition does not seek review of any Phase II rulings.

REASONS WHY THE PETITION SHOULD BE DENIED

This case does not merit review. The decision below presents none of the established grounds for exercise of certiorari jurisdiction and, in any event, is plainly correct in the aspects challenged by petitioner.

The decision below is not in conflict with the decisions of this Court or any other court of appeals, and the court below did not depart from the accepted and usual course of judicial proceedings. Nor does the case present any novel or important question of federal law. Rather, it merely represents a straightforward application of settled California law regarding an insurer's defense obligations to a specific set of facts.

Nor is there any reason to hold this petition in abeyance pending the Court's decision in *BMW of North America, Inc. v. Gore, cert. granted*, 63 U.S.L.W. 3555 (U.S. Jan. 23, 1995) (No. 94-896). The constitutional issues presented in *BMW* have nothing in common with this case. First, unlike the defendant in *BMW*, Liberty has not been punished for transactions that occurred outside the state. Liberty's offending conduct took place entirely in California. Thus, the due process problem of extraterritorial punishment is not presented here.

Mutual and/or Chemstar in any proceeding, including any appellate proceeding relating to the Phase I judgment." (Chemstar's Phase II SUPP-C 20-25)

Given the above stipulation, the court of appeals found that Liberty's attempt to exonerate itself from liability to Chemstar based upon Phase II exhaustion rulings was "untenable." (Pet. App. 46a) The court also correctly noted that "Liberty cannot use a later decision on coverage to dispute the district court's earlier decision on duty to defend." (Pet. App. 30a) Liberty nevertheless continues to violate the stipulation (Pet. at 9), and its references to the Phase II exhaustion ruling in its petition are similarly untenable here.

Second, in the *BMW* case, the punitive damages were 500 times the compensatory damages. Accordingly, the petitioner in *BMW* raised questions as to excessiveness. In this case, the punitive damages were limited to five times the compensatory damages. Given that reasonable ratio and the well-supported findings of the trial court and court of appeals as to the gravity of Liberty's misconduct, whatever may be the result in *BMW*, that case will have no bearing on the correctness or reviewability of the decision below. Thus, the petition should be denied now; there is no reason to hold it for *BMW*.

I. THE LOWER COURTS' PROCEDURAL RULINGS PRESENT NO *ERIE* QUESTION OR OTHER ISSUE WARRANTING THIS COURT'S REVIEW.

With respect to the first Question Presented in the petition, this is a straightforward diversity action involving a district court's decision to bifurcate, under Rule 42 of the Federal Rules of Civil Procedure, the trial of the state law questions. Essential to Liberty's position is its attack on the trial court's evidentiary rulings in the different phases of trial. These evidentiary and procedural rulings do not qualify for this Court's consideration.

Petitioner's only effort to bring these procedural rulings within any of the recognized grounds for certiorari rests on the assertion that the rulings are somehow contrary to this Court's decision in *Erie R. Co. v. Tompkins*, 304 U.S. 64 (1938). Putting aside the problem that it was petitioner who removed the case to federal court in the first place—and thus hardly is in the position to invoke the "forum shopping" underpinning of *Erie*[6]—the assertion is baseless because there is no conflict between state and federal law. The real question Liberty presents is merely whether the trial court abused its discretion. That question clearly is not an appropriate basis for certiorari jurisdiction.

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[6] *Hanna v. Plumer*, 380 U.S. 460, 468 (1965); *see* Liberty's Petition ("Pet.") at 19-20 n.13.

A. Bifurcation Under Rule 42 Did Not Conflict With Any State Law.

Most fundamentally, there is no conflict between state and federal law, a fact which Liberty concedes.[7] First, bifurcation of the trial on duty to defend issues from ultimate indemnity issues was fully consistent with California substantive law regarding an insurer's duty to defend, and did not "alter" Liberty's rights. As the courts below recognized, California law imposes a duty on insurers to defend all claims that create a *potential* for coverage under a liability policy, regardless of whether the insurer ultimately is held liable for indemnification under the policy.[8] *See* further discussion in Point II, *infra*.

Second, Rule 42(b) bifurcation also accords with the procedure permitted under state law. California state courts are vested with the same discretion to bifurcate a trial when the "convenience of witnesses, the ends of justice, or the economy and efficiency of handling the litigation would be prompted thereby." CAL. CIV. PROC. CODE § 598. *See also* CAL. CIV. PROC. CODE § 1048(b) (court may order separate trial of any cause of action or any issue). A California state court judge's discretion to order separate trials will not be reversed absent an abuse of discretion. *McLellan v. McLellan*, 23 Cal. App. 3d 343, 353, 100 Cal. Rptr. 258, 264 (1972). Liberty cites no California decisional law which would have prohibited bifurcation had the matter remained in state court.[9]

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[7] Liberty acknowledges in its petition that there is no "patent difference between two competing procedural rules, as in prior *Erie* cases." (Pet. at 18)

[8] *See, e.g., Horace Mann Ins. Co. v. Barbara B.*, 4 Cal. 4th 1076, 17 Cal. Rptr. 2d 210, 846 P.2d 792 (1993); *Montrose Chem. Corp. v. Superior Court*, 6 Cal. 4th 287, 24 Cal. Rptr. 2d 467, 861 P.2d 1158 (1993); *Gray v. Zurich Ins. Co.*, 65 Cal. 2d 263, 54 Cal. Rptr. 104, 419 P.2d 168 (1966).

[9] Liberty's reliance on *Downey Sav. & Loan Ass'n v. Ohio Cas. Ins. Co.*, 189 Cal. App. 3d 1072, 1086, 234 Cal. Rptr. 835, 841 (1987),

Finally, even assuming differences in the application of Rule 42(b) and its state law counterparts, the incidental effects of any such differences on the litigants here would not violate the commands of *Erie* and the Rules Enabling Act. *See, e.g., Hanna v. Plumer*, 380 U.S. 460, 465, 473-74 (1965); *Byrd v. Blue Ridge Rural Elec. Coop., Inc.*, 356 U.S. 525, 540 (1958). Liberty's contention that Rule 42 was "misapplied" by the district court under the particular facts of this case (Pet. at 12, 20) simply does not raise any *Erie* question at all, let alone a substantial federal question warranting review. *Hanna v. Plumer*, 380 U.S. at 469-70.[10]

B. Liberty's Challenges to Evidentiary Rulings Are Not an Appropriate Subject for Review.

Liberty contends that the bifurcation order precluded it from introducing "crucial evidence" at the Phase I trial, thereby allegedly altering its state law rights. (Pet. at 11-12, 27) Liberty's complaint constitutes nothing more than its disagreement with the district court's evidentiary

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cert. denied, 486 U.S. 1036 (1988) is misplaced, because that case did not involve a liability policy where an insurer has an obligation to defend based upon the potential for coverage. Rather, *Downey* involved an action against an insurer for denial of benefits under a fidelity bond where the appellate court found that the trial court did not abuse its discretion by denying a request by the insurer to bifurcate trial on the denial of coverage claim from the breach of the implied covenant claim. Similarly, *Cook v. Superior Court for County of San Diego*, 19 Cal. App. 3d 832, 833, 97 Cal. Rptr. 189 (1971), did not concern bifurcation in the context of an insurance dispute.

[10] Rule 42(b), of course, is entitled to strong presumptive validity under *Hanna*, and is properly treated as controlling federal procedural law. *See, e.g., Sellers v. Baisier*, 792 F.2d 690, 694 (7th Cir. 1986) (bifurcated trials are permissible in federal court even where state law employed to determine substantive issues prohibits bifurcated trials); *Rosales v. Honda Motor Co.*, 726 F.2d 259, 262 (5th Cir. 1984) (district court's bifurcation of trial did not implicate *Erie*).

rulings in a fact-intensive, state law trial. *See Hirst v. Gertzen,* 676 F.2d 1252 (9th Cir. 1982). There is no basis for review. *United States v. Johnston,* 268 U.S. 220, 227 (1925) ("We do not grant certiorari to review evidence and discuss specific facts.").

Evidence relating to other insurers, other claims, retrospective premiums, and policy limits (Pet. at 13, 18) was not excluded because of bifurcation, but rather because such evidence was not relevant to Liberty's breach of its duty to defend and its covenant of good faith and fair dealing. (Pet. App. 87a) *See, e.g., Montrose Chem. Corp. v. Superior Court,* 6 Cal. 4th at 300 ("[f]acts merely tending to show that the claim is not covered, or may not be covered, but are insufficient to eliminate the possibility that resultant damages (or the nature of the action) will fall within the scope of coverage, therefore add no weight to the scales"). Contrary to Liberty's suggestion, state law does not entitle Liberty to the admission of irrelevant evidence, nor do the cases Liberty cites so state. *E.g., Walbrook Ins. Co. v. Liberty Mut. Ins. Co.,* 5 Cal. App. 4th 1445, 1455, 7 Cal.Rptr. 2d 513 (1992). Thus, the court of appeals properly concluded that the district court's evidentiary rulings were not in error; "Liberty has failed to show that this evidence was relevant or that its exclusion resulted in substantial injustice." (Pet. App. 34a)

In any event, Liberty presented all relevant evidence regarding its intent and understanding, as the court of appeals expressly found. (Pet. App. 35a) For example, Liberty was permitted to introduce testimony of its decisionmaker's perceptions of other persons' interests (RT 1370-71); to give legal conclusions relating to coverage (RT 1361, 1365-66); to introduce hearsay evidence based on the "state of mind" exception (RT 1363); and to introduce otherwise inadmissible evidence so long as it pertained "to what the witness knew and had in his mind at the time he made the decisions." (RT 1349) As for

policy limits and retrospective premiums, Liberty's decisionmaker testified that these considerations had nothing to do with his decision to deny coverage. (RT 1332; SUPP 178)

II. THE BIFURCATION DECISION WAS CLEARLY CORRECT, AND INVOLVED NO ABUSE OF DISCRETION.

In the procedural aspects challenged by petitioner, the decision below is not merely unremarkable. It is plainly correct.

There was no "misapplication" of Rule 42 by the courts below. The district court's decision to bifurcate the trial was grounded in the applicable state substantive law governing an insurer's obligations to its insured. Because California law provides that an insurer's duty to defend is separate and distinct from the duty to indemnify, the district court elected to adjudicate these issues separately. The decision to bifurcate the trial in this manner was within the sound discretion of the trial judge, and was affirmed under the appropriate standard of review by the Ninth Circuit. See *Hirst v. Gertzen*, 676 F.2d at 1261 (district court's decision to bifurcate must be upheld absent an abuse of discretion).

California law is settled that the duty to defend is broader than the duty to indemnify. An insurer must defend any action which creates even a potential for coverage under its policy. *Montrose Chem. Corp. v. Superior Court*, 6 Cal. 4th at 295; *Gray v. Zurich, supra.* It is also settled that the duty to defend is determined at the outset of the case, and exists " 'even where coverage is in doubt and ultimately does not develop.' " *Montrose*, 6 Cal. 4th at 295 (quoting *Saylin v. California Ins. Guar. Ass'n*, 179 Cal. App. 3d 256, 263, 224 Cal. Rptr. 493 (1986)). Thus, the court of appeals below correctly stated that "[i]f the insurer could justify its refusal to defend on the argument that coverage was not yet de-

cided, the duty to defend would collapse into the duty to indemnify." (Pet. App. 34)[11]

The California Supreme Court's recent decision in *Montrose* reaffirms the broad scope of an insurer's defense obligation, and well illustrates the lack of merit in Liberty's challenges to bifurcation. In *Montrose*, the plaintiff-insured had been sued by the United States and the State of California in an action for recovery costs under the Comprehensive Environmental Response Compensation and Liability Action of 1980 (42 U.S.C. § 9607, *et seq.*) ("CERCLA"). Montrose gave notice of the action to its insurers that had issued liability policies from 1960 to 1986, and asked the insurers to defend it. The insurers declined to accept the defense.

Montrose then brought an action against its insurers seeking an adjudication that they had a duty to defend the actions. The California Supreme Court affirmed the appellate court's determination that the insurers were required to defend and reiterated that "[a] liability insurer owes a broad duty to defend its insured against claims that create a *potential* for indemnity." 6 Cal. 4th at 295 (emphasis added). When potential liability is established by reference to the complaint, the terms of the policy, and extrinsic evidence, "the insurer must assume its duty to defend *unless and until it can conclusively refute that potential.*" *Id.* at 299 (emphasis added). The California Supreme Court also noted that, to avoid the possibility

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[11] Liberty cites no authority for the proposition that insurance coverage actions are frequently bifurcated to resolve coverage issues before breach of contract issues. (Pet. 12, n.9) Moreover, Liberty's assertion is contrary to the settled California rule that the duty to defend is determined based upon the existence of the *potential* for coverage. *Gray v. Zurich Ins. Co.*, 65 Cal. 2d at 276-277, 54 Cal. Rptr. at 112-113. As Liberty itself acknowledges in its petition, "California law requires that an insurer's duty to defend is measured by the complaint against the insured not by a hindsight consideration of whether the claim turns out to be covered." (Pet. at 18)

that a refusal to defend will subject the insurer to liability for bad faith, the insurer may seek a judicial determination that it owes no defense. *Id.* at 301.

As Liberty notes in its petition, the California Supreme Court is expected to decide the indemnification issue (relating to the "trigger" of coverage) in a second decision in the *Montrose* action, which has not yet been scheduled for argument. Thus, the California Supreme Court has effectively approved a procedure in *Montrose*—*i.e.*, deciding duty to defend issues before ultimate coverage issues—which exactly parallels the procedure followed by the district court here.[12]

Liberty also claims that the bifurcation order deprived it of its state law contribution rights against other insurers. (Pet. at 17-19) Liberty's assertion is incorrect for two reasons. First, evidence of the obligations of other insurers would have been entirely irrelevant to whether Liberty breached its duty to defend Chemstar, because California law is settled that an insurer's obligation to defend is independent of the obligations of other insurers. *Wint v. Fidelity & Cas. Co.*, 9 Cal. 3d 257, 263, 107 Cal. Rptr. 175, 179 (1973).[13] Second, the bifurcation order did not deprive Liberty of its claims against other insurers for contribution. Liberty fully litigated (and lost)

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[12] None of the cases cited by Liberty at page 15 of its petition involved bifurcation of duty to defend issues from ultimate coverage issues. For example, *Response of Carolina, Inc. v. Leasco Response, Inc.*, 537 F.2d 1307, 1324 (5th 1976), involved an antitrust case where the court noted that bifurcation between liability and damages should be "approached with trepidation" because the "dividing line between violation and damages is difficult to draw." The other cases cited by Liberty are similarly inapposite because they did not involve an insurer's defense obligations.

[13] Pursuant to California law, an insurer who has honored its obligation to defend its insured may maintain an equitable action against a breaching insurer for contribution to defense costs. *Continental Cas. Co. v. Zurich Ins. Co.*, 57 Cal. 2d 27, 37, 17 Cal. Rptr. 12, 18, 366 P.2d 455 (1961).

such claims in Phase II of this action. (Pet. App. 48a, 104a).

In short, Liberty has completely failed to demonstrate that the lower court "so far departed from the accepted and usual course of judicial proceedings" as to call for the exercise of the Court's supervisory jurisdiction. S. Ct. R. 10.1(a). In granting bifurcation of trial on Liberty's breach of the duty to defend from other issues, the district court not only fully conformed to the applicable substantive law, but also acted well within the range of discretion necessarily vested in trial courts to manage efficiently their dockets. Accordingly, the petition should be denied.

III. THE PUNITIVE DAMAGES AWARD FULLY CONFORMS TO THIS COURT'S PRIOR DECISIONS, RAISES NO NEW DUE PROCESS ISSUES, AND WILL NOT BE AFFECTED BY THE RESULT IN *BMW*.

Contrary to Liberty's claim, there is no reason for the Court to grant certiorari to consider whether the punitive damages were excessive in this case. Reduced to its essence, Liberty's attack on the punitive damages award is nothing more than a request for a trial *de novo* on the facts which the jury, trial judge and court of appeals found supported the award. Review should be denied.

The due process issues Liberty raises have been resolved by the Court in *Pacific Mut. Life Ins. Co. v. Haslip*, 499 U.S. 1 (1991) ("*Haslip*"), and *TXO Prod. Corp. v. Alliance Resources Corp.*, 113 S. Ct. 2711 (1993), in which the Court held that the common law method of assessing punitive damages afforded procedural due process. The common law approach, faithfully employed by the courts below, provides that the jury is instructed to consider the purpose of puntive damages and to consider the seriousness of the injury and the amount needed to deter the misconduct. The trial court then reviews the

award for excessiveness. Finally, the appellate court reviews the award. *Haslip*, 499 U.S. at 15. "Assuming that fair procedures were followed, a judgment that is a product of that process is entitled to a strong presumption of validity. Indeed, there are persuasive reasons for suggesting that the presumption should be irrebuttable." *TXO Prod. Corp.*, 113 S. Ct. at 2720.

As demonstarted below, in this case Liberty had the benefit of the "full panoply" of California protections to ensure the validity of punitive damages.[14] *Haslip*, 499 U.S. at 3. Under these circumstances, Liberty's petition is without merit.

A. Objective Factors Demonstrate That the Punitive Damages Were Reasonable.

Despite Liberty's complete failure to raise any issue not settled by this Court's prior decisions, Liberty continues to argue that the facts established at trial were insufficient to support the jury's finding that punitive damages were appropriate. In fact, this case suggests no indicia of unreasonableness, and the evidence was more than sufficient to support the jury's finding that Liberty acted with "fraud, oppression or malice" under applicable California law.

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[14] Liberty does not raise any challenge to the jury instructions in its petition, nor could it. The jury was properly instructed under California Civil Code Section 3294, pursuant to which Chemstar was required to establish by clear and convincing evidence that Liberty acted with oppression, fraud or malice toward Chemstar. In assessing punitive damages, the jury was instructed to consider: (1) the reprehensibility of the defendant's conduct; (2) the amount of punitive damages that would have a deterrent effect on the defendant in light of its financial condition; and (3) whether the award bore a reasonable relationship to the harm actually suffered. Whether to award punitive damages at all was within the discretion of the jury. (Pet. App. 70) "The instructions thus enlightened the jury as to the punitive damages' nature and purpose, identified the damages as punishment for civil wrongdoing of the kind involved, and explained that their imposition was not compulsory." *Haslip*, 499 U.S. at 19.

Most fundamentally, this is not a case where an insurer "guessed wrong," as Liberty contends. Substantial evidence established that Liberty was aware of its obligations to Chemstar and of the probable consequences of its wrongful denial of those obligations. (See discussion at pp. 3-4 *supra*) At trial, Liberty chose to defend its conduct by claiming that it believed that Chemstar was not an insured under its policies, a contention which the trial judge found "stirs the blood." (Pet. App. 78a). Liberty's internal documents and the testimony of its employees established that Liberty knew that Chemstar was an insured and knew that Chemstar was entitled to a defense.

Furthermore, the dispute leading to the imposition of punitive damages did not, as Liberty claims, concern a mere business dispute arising out of reasonable but differing interpretations of insurance coverage. As set forth above, this is not a case, as Liberty suggests, where there was any factual or legal basis for its abandonment of Chemstar's defense.[15] California law has been established for at least 30 years that an insurer is required to defend its insured if there is a *potential* for coverage under the policy. *Gray v. Zurich Ins. Co.*, 65 Cal. at 276-277.

In this case, the evidence established that: (1) Liberty knew from the beginning the full facts concerning Chemstar's acquisition of Liberty's named insured, Genstar Lime, and Liberty's resulting obligations to Chemstar;

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[15] Liberty implies in its petition, as it did in the Phase II proceedings below, that *Whittaker Corp. v. Allianz Underwriters, Inc.*, 11 Cal. App. 4th 1236, 14 Cal. Rptr. 2d 265 (1992), provides authority for its withdrawal from the defense in 1989. Liberty's reliance on *Whittaker* is misplaced. As the Ninth Circuit found in its Phase II opinion, *Whittaker* "never directly addressed" the coverage issue decided by the lower courts. (Pet. App. 24a) Rather, the issue in *Whittaker* was whether a claim arises at the time of the act that causes damage or at the time of manifestation. (Pet. App. 24a) Furthermore, neither *Whittaker* nor any other case could exonerate Liberty from honoring its duty to defend Chemstar. As correctly stated by the Ninth Circuit, "[a]ll that is necessary [for the duty to defend] is the *potential* of coverage." (Pet. App. 34a)

(2) Liberty knew that there was at least a potential for coverage under the Genstar Lime policies, based on the recommendations and conclusions of its own claims personnel; and (3) nothwithstanding this knowledge, Liberty abandoned the defense of Chemstar without consulting its claims personnel or reviewing its written guidelines, without contacting its insured, and without seeking any judicial determination of its obligations, after handling Chemstar's defense for nearly three years without a reservation of rights. (Pet. App. 78a). As the court of appeals recognized, this amounts to clear and convincing evidence that Liberty willfully abandoned Chemstar in breach of the duty of good faith inherent in the relationship between an insurer and its insured.[16]

Contrary to Liberty's assertion (Pet. at 24), the "harm" at stake to Chemstar was not the mere possibility of Liberty incorrectly declining to provide coverage under an insurance policy. The harm to Chemstar was predictable and grievous. Within two month of Liberty's decision to abandon Chemstar, approximately 15 to 20 homeowners who were concerned that their claims would be ignored filed lawsuits against Chemstar. (RT 715) Moreover, Chemstar was forced to begin its defense from scratch, which greatly increased its attorneys' fees and experts' costs. (RT 1262) Moreover, Liberty's principal witness admitted it was "pretty obvious" that Chemstar would be seriously affected by the decision to deny all coverage. (RT 1475-76; SUPP 225-26) In short, the abandonment of Chem-

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[16] While a "pattern and practice" of the defendant may be a relevant factor with respect to punitive damages. (*TXO Prod. Corp.*, 113 S. Ct. at 2722, n.28), Chemstar was not required to present evidence that Liberty's misconduct was part of such a "pattern" (Pet. at 23) under either California law or this Court's decisions. Additionally, Liberty's assertion that punitive damages were inappropriate because Liberty allegedly did not profit from its conduct toward Chemstar (Pet. 25-26) is contrary to evidence from which the jury could have reasonably determined that Liberty intended to and did derive a substantial financial gain by withholding insurance benefits due Chemstar.

star was calculated to and did leave Chemstar in the worst possible position.

This evidence was clearly sufficient for the jury to find malice and oppression. The jury also could well have found that Liberty fraudently misrepresented the facts regarding Chemstar's insurance coverage and consciously disregarded its rights, as the Ninth Circuit concluded. (Pet. App. 40a).

B. A Reasonable Relationship Exists Between the Harm and the Award.

This Court has held that a mathematical bright line cannot be drawn between a constitutionally acceptable and a constitutionally unacceptable award of punitive damages. *Haslip*, 499 U.S. at 18. While there is no litmus test for determining whether an award is constitutionally acceptable, "a 'general concern for 'reasonableness . . . properly enters into the calculus.'" *TXO Prod. Corp.*, 113 S. Ct. at 2720, quoting *Haslip*, 499 U.S. at 18. A relevant consideration for reasonableness is that the punitive damages should bear a reasonable relationship to the harm that has actually occurred. *TXO Prod. Corp.*, 113 S. Ct. at 2720.

In this case, Liberty's conduct was found to be "egregious" (Pet. App. 79a), and the magnitude of harm to Chemstar was substantial: $2.8 million, according to the jury's special verdict. Given these facts, the $14 million punitive damages award was reasonably related to the nature and extent of the harm. The punitive damages award was five times the amount of Chemstar's compensatory damages. This five-to-one ratio is far less than the ratio in *TXO*. *See TXO Prod. Corp.*, 113 S. Ct. at 2718 (affirming a punitive damages award 526 times greater than the actual damages); *see also Haslip*, 499 U.S. at 23 (punitive damages four times the amount of compensatory damages and 200 times the out-of-pocket expenses). The award simply does not approach the

"outer limit" of reasonableness on awards of punitive damages. *TXO Prod. Corp.*, 113 S. Ct. at 2720, n.24.

C. Liberty's Financial Worth Further Supports the Award.

The net worth of the defendant is a relevant factor in determining the amount of punitive damages necessary to provide a financial deterrent inducing the defendant to change its future behavior. *TXO Prod. Corp.*, 113 S. Ct. at 2723. In this case, the $14 million punitive damage award constitutes roughly two-thirds of one percent of Liberty's $2.1 billion surplus. (Pet. App. 40a) This too demonstrates that the punitive damages award was reasonable under the particular circumstances.

D. The Review Conducted by the District Court and the Court of Appeals Satisfied Due Process Requirements.

In *TXO Prod. Corp.*, the Court considered and rejected the same argument that Liberty makes here: that the lower courts' review was too "cursory" to satisfy due process requirements. (Pet. at 29) *See TXO Prod. Corp.*, 113 S. Ct. at 2724 ("While it is always helpful for trial judges to explain the basis for their rulings as thoroughly as is consistent with the efficient dispatch of their duties, we certainly are not prepared to characterize the trial judge's failure to articulate the basis for his denial of the [defendant's] motions . . . as a constitutional violation.").[17]

Contrary to Liberty's claim, the district court engaged in a thoughtful analysis of the relevant factors regarding the reasonableness of the award. The district court reviewed in detail the facts established at trial regarding Liberty's

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[17] The procedures followed by the courts below bear no resemblance to the constitutional deficiency of the law at issue in *Honda Motor Co. v. Oberg*, —— U.S. ——, 114 S. Ct. 2331 (1994), in which Oregon impermissibly denied any judicial review of compensatory or punitive damages for excessiveness.

conduct, and noted that Liberty's "conclusion that Chemstar was not an insured inexplicable, even astounding . . . ." (Pet. App. 77a) The district court concluded that the jury's determinations "were solidly based in the evidence." (Pet. App. 79a) As noted above, the district court also concluded that the "facts in the case were as egregious as the court has ever seen in an insurance bad faith case in 20 years as a judge." (Pet. App. 79a)[18]

The court of appeals also considered the relevant factors bearing on the reasonableness of the award—including the reprehensible nature of Liberty's conduct, the relationship between the award and the actual harm, and Liberty's wealth—and concluded that the district court did not abuse its discretion in upholding the punitive damages award. The court of appeals expressly acknowledged that punitive damages are not available for even "gross or willful" breaches of contract, but require an insurer to have "acted maliciously, with an intent to oppress, and in conscious disregard of the rights of the insured." (Pet. App. 39a) The court then concluded that, "from evidence presented at trial, the jury could have inferred that Liberty fraudulently misrepresented facts regarding Chemstar's coverage and consciously disregarded Chemstar's rights under the policy." (Pet. App. 40a)

The Ninth Circuit also considered the award in the context of other punitive damages awards upheld by California courts, and found that California courts had upheld awards with much larger ratios between punitive damages and compensatory damages, and which constituted larger percentages of net worth (Pet. App. 40a)[19] Based on the

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[18] At trial, Chemstar called an industry expert, Edward McKinnon, who testified that Liberty's conduct constituted the worst bad faith failure to defend that he had ever seen. (RT 837-38; SUPP 171)

[19] The Ninth Circuit noted *Moore v. American United Life Ins. Co.*, 150 Cal. App. 3d 610, 636, 197 Cal. Rptr. 878 (1984) (83:1 ratio between compensatory damages and punitive damages), and *Chodos v. Ins. Co. of N. Am.*, 126 Cal. App. 3d 86, 103, 178 Cal.

entire record, the Court concluded that the award was not excessive as a matter of law. (Pet. App. 40a)

E. There Is No Reason to Hold This Petition Pending the Decision for *BMW*.

Whatever this Court may hold in *BMW*, this decision would not be affected. The constitutional issues presented in *BMW* are not at issue in this case, where there is no question of extraterritorial punishment. Further, in this case, neither the amount of punitive damages nor the findings below raise any issue as to excessiveness. Thus, there is no reason to hold this petition pending the decision in *BMW*.

CONCLUSION

For the foregoing reasons, the petition for writ of certiorari should be denied.

Respectfully submitted.

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Rptr., 831 (1982) (40:1 ratio between compensatory damages and punitive damages).

(3)

Supreme Court, U.S.
FILED
MAR 2 0 1995
OFFICE OF THE CLERK

No. 94-1337

In The

Supreme Court of the United States

October Term, 1994

LIBERTY MUTUAL INSURANCE COMPANY,

Petitioner,

v.

CHEMSTAR, INC. AND NATIONAL UNION FIRE INSURANCE CO. OF PITTSBURGH, PA.,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals, Ninth Circuit

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INTRODUCTION

Much of Chemstar's Opposition deals with its view of the facts of its coverage dispute with Liberty Mutual Insurance Company. Liberty will not reply in kind, although it has quite a different view of those facts. The *legal* issues which are the focus of these proceedings do not concern Chemstar's reaction to Liberty's coverage decision. Instead, the legal issues involve whether the manner in which the trial court proceeded misused procedural rules to improperly change substantive rights, and improperly allowed substantial punitive damages to be awarded against Liberty for making decisions, in the context of a complex commercial dispute, where even the court below admitted that decisional law (which the court chose not to follow) favored Liberty's position.

I.

THE TRIAL COURT'S SUA SPONTE BIFURCATION OF THE CASE TO DETERMINE ONE INSURER'S (LIBERTY'S) "BAD FAITH" IN A FIRST TRIAL ALTERED LIBERTY'S SUBSTANTIVE RIGHTS

Many of the observations Chemstar makes in its discussions of the bifurcation issue support Liberty's position more than they detract from it. Several times Chemstar emphasizes that under the governing California law an insurer's duty to defend must be assessed as of the time the claim is asserted against the policyholder. Chemstar makes this point to argue that Liberty was properly held obligated to defend Chemstar, but the point applies as strongly to Chemstar's direct insurer,

respondent National Union.[1] National Union had at least the same duty to defend the claims against Chemstar as Liberty, but it was absolved of its obligation solely because of the manner in which the trial court considered the issues. Had the trial court first held a "damages/duty to defend" trial as to National Union or all insurers in the case, instead of as to Liberty alone, some of the damages assessed against Liberty would have been awarded against National Union instead.[2] Rules of procedure cannot alter state-created substantive rights as they were allowed to do in this instance.

Chemstar argues that Rule 42(b) "is entitled to strong presumptive validity under *Hanna* . . . ," (Opposition ("Oppo.") at p. 11, n. 10) as though Liberty were attacking the validity of bifurcation generally. Chemstar misses Liberty's point. Bifurcation is often an appropriate procedural device under the right circumstances, but that

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[1] As noted in Liberty's petition, Liberty never insured Chemstar directly. Liberty insured Genstar Corporation, which owned the subsidiary which sold its lime business to the company that became Chemstar. The date of the sale was December 5, 1986, and Genstar instructed Liberty to cancel its coverage for the lime business as of that date. Chemstar purchased its primary coverage from National Union for almost three years after that, from December 5, 1986 until October 1, 1988.

[2] In Part III of its opposition Chemstar argues that there is no impermissible disproportion between the punitive and compensatory damages awarded against Liberty. Almost all of the compensatory damages assessed against Liberty in the Phase I trial related to Liberty's failure to defend Chemstar. To the extent a significant portion of these amounts are National Union's obligation, the punitive damages award becomes further suspect.

does not mean that it can be used to change parties' substantive rights and obligations among themselves. The two cases cited by Chemstar[3] as supporting the use of bifurcation here are inapposite, because both involved straightforward bifurcations of liability and damages. In neither case was there any concern that the substantive liability result was affected by the bifurcation. In the present case the bifurcation, coupled with the evidentiary rulings on what Liberty would be allowed to present to the jury during its bad faith trial, did have that effect, which is one reason the present case is deserving of review.

Chemstar is also wrong when it contends (Oppo. at p. 15) that Liberty's position is easily disposed of because duty to defend issues are often resolved prior to associated indemnity issues, and that "exactly parallels" what occurred here. No such parallel exists. Here the court moved from one insurer's duty to defend, to a bad faith damages trial respecting that insurer only, to coverage as to all parties. There is nothing inherently improper in considering duty to defend as to all insurers in a case separately from ruling on other coverage issues, and Liberty does not argue that there is. Where the court erred here was in selecting one of several insurers, Liberty, to stand trial on damages arising out of the duty to defend, to allow a jury to impose all compensatory and punitive damages and to impose all defense obligations on that one insurer before addressing "coverage issues." As a result of the strange way in which it compartmentalized

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[3] *Sellers v. Baisier*, 792 F.2d 690 (7th Cir. 1986); *Rosales v. Honda Motor Co.*, 726 F.2d 259 (5th Cir. 1984).

the parties and issues, the court both denied Liberty the right to present evidence that would undercut Chemstar's bad faith arguments, and applied a different duty to defend standard to Liberty than to National Union.

There are two responses to Chemstar's argument that Liberty is merely protesting evidentiary rulings by the trial court, and that Liberty had no right to have the jury consider irrelevant evidence. First, the evidence which the trial court refused to allow Liberty to present during the Phase I "damages/duty to defend" trial could be termed "irrelevant" only because of the strange bifurcation which the trial court adopted. Second, this evidence went to the heart of Chemstar's highly emotional bad faith argument to the jury during Phase I, which was what Liberty was trying to avoid a "big hit" on the plaster pitting cases, and needed to be punished severely to "send a message" to the company's management.

Chemstar is wrong in arguing that the result reached in this case can be reconciled with California law. (*See* authorities cited and discussed at pages 16-17 of Liberty's Petition.) California law holds that an insurer charged with bad faith is entitled to have the jury consider *all* of the circumstances pertinent to the insurer's conduct. That was not allowed to happen in the case at bar solely because of the manner in which the issues were bifurcated.[4]

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[4] Chemstar's argument at pages 12-13 of its Opposition – that the evidence Liberty was not allowed to present was properly excluded because Liberty's claims personnel did not rely upon these factors in deciding that the Liberty policies did not apply to Chemstar – misses the point. The evidence in question

II.

THIS COURT SHOULD REVIEW THE $14 MILLION PUNITIVE DAMAGES AWARD IMPOSED AGAINST LIBERTY

A. The Award of Punitive Damages in This Case Violates Due Process

Chemstar does not dispute that an award of punitive damages, in order to comport with due process under the U.S. Constitution, must be "reasonable" under the circumstances of that case. (*TXO Production Corp. v. Alliance Resources Corp.*, 113 S.Ct. 2711 (1993); Oppo. at p. 20.) Further, Chemstar cannot and does not dispute the basic character of the conflict in this case that gave rise to the imposition of punitive damages, *i.e.*, a dispute over whether insurance policies issued by Liberty to one company (Genstar) provide coverage to a different company (Chemstar) for claims that arose after the Liberty policies were cancelled by the insured.

An insurer's coverage decisions are based on facts concerning the claim, based on the express policy terms, and based as well on the relevant law. The factual context

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was that Liberty's limits of coverage were much more modest than the $40 to $50 million "hit" referred to by Chemstar, that under its policies with Genstar Liberty could charge back substantial premiums based on defense and indemnity expenses, and that Liberty was close to exhausting its coverage by handling the plaster pitting cases on behalf of Genstar and related entities in any event. Those facts naturally were not the basis for Liberty's coverage decision, but they strongly contradict Chemstar's (successful) argument to the jury that Liberty based its decision on improper financial considerations in the hope of avoiding Chemstar's mythic "big hit."

in which claims are presented is fluid. Examples of fluid facts affecting coverage in this case include the corporate changeover from Genstar to Chemstar (App. 76a) and express cancellation of coverage under the Liberty policies before the first suit (the Friedman lawsuit) arose. (*See*, App. 108a.) The legal environment is fluid as well. Cases are decided regularly that affect some aspect of coverage in virtually any large commercial dispute. For example, in the present case, although the precise trigger of coverage issue present here had not been addressed by the California courts, the Court of Appeals acknowledged that Liberty applied the "closest" case that had been decided. (App. 23a [9th Circuit acknowledged that *Whittaker Corp. v. Allianz Underwriters, Inc.*, 14 Cal.Rptr.2d 659 (Cal. App. 1992) is the "closest case" and arguably supports Liberty's coverage position].)

Liberty also followed valid case authority for its determination that Chemstar, which at no time purchased insurance from Liberty, did not *become* an insured by its involvement in a series of complicated mergers and acquisitions. (*Northern Ins. Co. of New York v. Allied Mutual Insurance Co.*, 955 F.2d 1353 (9th Cir. 1992); see also *Quemetco, Inc. v. Pacific Automobile Ins. Co.* 29 Cal.Rptr.2d 627 (Cal.App. 1994).) The Ninth Circuit brushed over these cases. (App. 27a.)

The question raised here is *not* whether this is a significant insurance dispute involving costly plaster disfigurement in various California homes. (*See* Oppo. at p. 19.) But the question raised by the multi-million dollar punitive damages award in this case, as in *BMW of North America v. Gore, cert. granted*, 63 U.S.L.W. 3555 (U.S. Jan. 23, 1995) (No. 94-896), is whether punitive damages can

be imposed in a commercial context where the punished party made reasonable decisions based on the law applicable to the underlying dispute.

Chemstar attempts to defend the reasonableness of the imposition of $14 million in punitive damages by referring to the wealth of Liberty. (*See, e.g.*, Oppo. at pp. 21, 22.) However, punitive damages that *result from* an insurer's declination of coverage based on its application of the "closest" existing law cannot be "reasonable" as defined in *TXO*. A $14 million dollar windfall to a substantial corporate insured (such as Chemstar) under theses circumstances does not become reasonable simply by pointing out that Liberty itself is a big company.

Chemstar's reliance on *Montrose Chemical Corp. v. Superior Court*, 24 Cal.Rptr.2d 467 (1993), *Horace Mann Ins. Co. v. Barbara B.*, 17 Cal.Rptr.2d 210 (1993) and *Gray v. Zurich Ins. Co.*, 54 Cal.Rptr. 104 (1966) – for the proposition that an insurer has a duty to defend an action whenever there is a potential for coverage – actually makes Liberty's point on the unreasonableness of punitive damages. It is also well established that an insurer may *decline* to provide coverage where the facts and the law show that the policy is inapplicable. Moreover, a dispute over legal issues concerning insurance policy interpretation, according to California law, cannot give rise to a duty to defend. (*State Farm Mutual Automobile Insurance Co. v. Longden* 142 Cal.Rptr. 726, 731 (Cal. App. 1987).)[5]

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[5] As set forth above, Liberty relied on valid case authority for declining coverage to Chemstar (*i.e.*, it relied on the "closest" case, *Whittaker, supra*, on the trigger of coverage issue, and on other cases such as *Northern, supra* and later *Quemetco, supra* for

Where an insurer, such as Liberty in this case, makes a coverage decision based on the law in existence at the time and the facts as known at the time, and where, as here, a court later *predicts* that the California Supreme Court will determine the *precise* issue involved in this case so as to implicate Liberty's policies, the denial of coverage cannot, as a matter of law, be determined to rise to the level of opprobriousness that would justify a punitive damages award of millions of dollars.[6]

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the proposition that Chemstar had no rights under policies purchased by – and cancelled by – Genstar. Even if Liberty and Chemstar had differing views of the legal effects of those cases, under *Longden* that dispute cannot give rise to a potential for coverage, much less a $14 million award of *punitive damages* resulting from such a scenario. Nonetheless, the Ninth Circuit panel expressly declined to follow *Longden*. (App. 29a, 41a.)

[6] Although divided on the matter, Liberty and Chemstar have informed this Court that cases are pending before the California Supreme Court at the present time which may determine whether the Ninth Circuit Court of Appeals' prediction regarding the ultimate coverage issue in this case is correct. (Petition at pp. 5-6; Oppo. at p. 5 [referring to pendency of *Montrose v. Admiral Ins. Co.* and *Stonewall Insurance Company v. City of Palos Verdes* in the California Supreme Court].) Oral argument has been scheduled in the *Montrose* case for April 5, 1995. A decision should be published within 90 days thereafter (Cal. Const., Art. VI, § 19) which may confirm or disaffirm the Ninth Circuit's prediction. Thus, we may know very shortly whether the $14 million dollar punishment inflicted on Liberty for its claims decision is not only unreasonable under the circumstances, but whether it is also fundamentally unjust because Liberty may have been right all along.

B. Liberty Was Not Afforded Meaningful And Adequate Review Of The Multi-Million Dollar Punitive Damages Award Assessed Against It

Chemstar does not deny, nor can it, that the trial court's review of punitive damages consisted of, at best, three conclusory sentences encompassed in the denial of post-trial motions. (App. pp. 78a-79a.) The trial judge merely stated that the punitive damages were supported by unspecified "evidence," that a punitive damages "instruction" was not in error "considering the instructions as a whole," and that the amount of punitive damages was related to actual damages. (App. pp. 78a-79a.) This stands in stark contrast to the analysis of punitive damages that was required by the Ninth Circuit pursuant to the due process clause in the U. S. Constitution in *Morgan v. Woessner*, 997 F.2d 1244 (9th Cir. 1993). The *Morgan* court ordered a district court to review a punitive damages award according to the seven specific factors and numerous sub-factors approved by the United States Supreme Court in *Pacific Mutual Life Ins. Co. v. Haslip*, 499 U.S. 1, 22-23 (1991) citing *Hammond v. City of Gadsden*, 493 S.2d 1374, 1379 (Ala. 1986).

The Court of Appeals' treatment of the multi-million dollar punitive damages award against Liberty is conceded to be likewise conclusory. (*See* Oppo. at pp. 22-23; App. 39a-40a.)

CONCLUSION

The punitive damages issues encompassed in *BMW of North America, Inc. v. Gore, supra*, pending before this

Court, are relevant to the punitive damages issues in this case. Fundamental to *BMW* is the question of whether a $2 million punitive damages award in a commercial context violates due process under the United States Constitution. In *BMW* the party against whom punitive damages were imposed complied with state law regarding repair of vehicles damaged in transit. Likewise, in this case, Liberty complied with applicable decisional law in making its coverage analysis. In *neither* case are millions of dollars in punitive damages "reasonable".

Certiorari should be granted here. At a very minimum, certiorari should be granted in this case pending the outcome of the *BMW* case before this Court. Certiorari should also be granted pending the outcome of the California Supreme Court's hearing in *Montrose* (n. 1, *supra*) bearing on the propriety of the District Court's prediction on the coverage issue giving rise to the punitive damages in this case.

Respectfully submitted,

DATED: March 17, 1995

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